30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **24 January 2008, London**

Project: **Amendments to IAS 24 Related Party Disclosures**

Subject: **Redeliberations: Follow-up issues – State-controlled entities (Agenda paper 8B)**

Purpose of this paper

1. The exposure draft of amendments to IAS 24 *Related Party Disclosures* proposed an exemption for state controlled entities (see appendix to this paper for relevant extracts). This paper discusses various aspects of the proposed exemptions.

Summary of recommendations

2. This paper recommends the following:

   (a) Paragraph 17A(b) describes one of the conditions that state-controlled entities must meet to qualify for the disclosure exemption for state-controlled entities. That paragraph should read: 'there are no indicators that either entity actually participated in the financial and operating policy decisions of the other entity in the periods covered by the financial statements.' (paragraphs 10-14 of this paper)

   (b) The following wording should be inserted as a new paragraph 17A(c) to implement the Board's tentative decision that influence by the state would block the exemption for state-controlled entities: 'there are no indicators that the state actually participated in those financial and operating policy decisions of either entity that had a direct effect on transactions between those entities in the periods covered by the financial statements.' (paragraph 15-17 of this paper)

(c) If transactions occur on non arms' length terms, that fact should not automatically block the exemption for all transactions with that counterparty. Instead, transactions on non arms' length terms should be an indicator that actual influence may exist over the financial and operating policy decisions, but would not demonstrate definitively that actual influence occurred. That indicator would have the same status as the other indicators proposed by the Board. (paragraph 18-21 of this paper)

(d) If the Board accepts the above recommendations, no further action is needed to deal with possible concerns about the volume of disclosure. (paragraphs 22-28)

Background

3. The following paragraphs summarise:

(a) the key underlying principles in IAS 24 (paragraph 4)

(b) the proposed exemption for state-controlled entities, published in February 2007 in an exposure draft of amendments to IAS 24 (paragraph 5)

(c) the tentative decisions made by the Board in October and November 2008 following its review of the responses to the exposure draft (paragraph 6)

4. Before continuing, it is convenient to establish a definition for use in this paper:

- a transaction is **on arms' length terms** if the same terms, including price, would apply if the transaction occurred between unrelated parties.

Principles in IAS 24

5. The key underlying principles in IAS 24 may be summarised as follows:

(a) In summary, a related party relationship exists:

(i) if one party controls, jointly controls, significantly influences or has significant voting power in another party. Significant influence is the power to participate in an entity's financial and operating policy decisions.

(ii) in some other specified cases (key management personnel, close family members of some other related parties and post-employment benefit plans).

(b) An entity must disclose all transactions with related parties, whether or not those transactions are on arms' length terms.

Exposure draft

6. In February 2007, the Board published an Exposure Draft *State-Controlled Entities and the Definition of a Related Party* (the ED). Among other things, the ED proposed that a state-controlled entity need not disclose transactions with a related party if:

(a) the parties are related only because the same state controls both parties, and

(b) there are no indicators that either party influenced the other.

7. The appendix to this paper contains relevant extracts from the ED.

Subsequent redeliberations

8. In its redeliberations in October and November 2007, the Board decided tentatively, among other things:

(a) not to include a specific materiality guideline for related party disclosures.

(b) that the proposed exemption for state-controlled entities would not be available if:

(i) either party influenced a transaction between it and the other entity; or

(ii) either entity influenced, ie participated in, the operating and financial policy decisions of the other entity. For both (i) and (ii), influence is sufficient to preclude the use of the exemption. Significant influence, as defined in IAS 24, is not required.

(c) if a transaction occurs on non arms' length terms (draft paragraph 17B(a)), the exemption would not be available. The remaining indicators proposed in the exposure draft (paragraphs 17(B)(b) and (c), 17C and 17D) would remain as indicators that influence might have occurred, rather than as definitive criteria that influence had occurred. The staff will consider the wording of those criteria (see appendix to this paper for the wording of the ED).

(d) when the reporting entity does not qualify for the exemption, it should disclose all transactions with the other state-controlled entity, regardless of whether those transactions are on arms' length terms.

(e) the proposed exemption would be available for entities that are subject to joint control by the state, rather than being limited to cases of control or significant influence by the state.

(f) the proposed exemption would not be available in cases of influence by a common state.

Overview of the rest of this paper

9. The rest of this paper discusses the following aspects of the Board's tentative conclusions to date:

(a) What sort of influence on a transaction should block the proposed exemption (paragraphs 10-17)?

(b) How does materiality apply in this context (paragraphs 18-21)?

(c) Would the proposed approach require disclosure of too many transactions in some markets (paragraphs 22-28)?

Influence

10. Applying the Board's tentative decisions in October, the exemption is not available if either party (or a common state) influences the transaction. For this purpose, influence is sufficient to block the exemption. Significant influence, as defined in IAS 24, is not required.

11. In any transaction, both parties influence the transaction. Influence of that sort (ie the normal influence of unrelated parties) cannot be sufficient to block the exemption, because otherwise the exemption would never apply. Therefore, what sort of influence should be sufficient? The natural answer is to think of the sort of influence that exists between related parties. In the definition of a related party, the key notion is significant influence. (Control and joint control could be viewed as extreme forms of significant influence.)

12. Significant influence has two main features:

   (a) Scope: The influence must be over **financial and operating policy decisions**.

   (b) Nature: The influence is the **power** to participate in those decisions. Actual participation in those decisions is not required.

13. The logic behind the ED is that related party transactions between state-controlled entities need not be disclosed if one entity did not actually exercise its power to participate in financial and operating policy decisions of the other entity. This suggests that actual influence over a **transaction** should block the exemption if (and only if) that influence reflects **actual** influence in financial and operating **policy** decisions (and not merely the **power** to participate in those decisions). In this context, the staff reads 'policy decisions' as referring to more significant decisions than decisions over individual transactions, unless the transactions are individually significant. Thus, actual influence over a large transaction, or a large number of small transactions, is likely to indicate actual participation in financial and operating policy decisions. However, that may not be the case when there is actual influence over a small number of small transactions.

14. Therefore, the staff recommends the following change to paragraph 17A(b):

   17A(b) there are no indicators that either entity actually participated in the financial and operating policy decisions of the other entity in the periods covered by the financial statements.

Influence by the controlling state

15. Respondents to the ED commented that, in practice, it is more likely that the controlling state would influence one of the transacting parties than that either transacting party would influence the other. Therefore, the Board decided tentatively in November that the exemption for state-controlled entities would not be available if the controlling state influenced either party. For the following reasons, it is necessary to amend slightly the approach recommended by the staff in paragraph 14 above:

   (a) The reporting entity can know whether it influenced, or was influenced by, the counterparty. However, it often does not know whether the state actually participated in the key operating and financial decisions of the other entity.

(b) The state may exercise actual influence over financial and operating policy decisions of one of the transacting parties without directly affecting transactions between the parties. For example, the controlling state might influence a decision to build a factory that is used to manufacture products sold to a wide range of entities, including some entities controlled by the same state. If the factory did not exist, the sale of the product could not occur. Thus, the influence on the decision to build the factory indirectly influences the subsequent sale of the product. However, arguably, that influence by the state is too indirect for related party disclosures about the resulting transactions to be necessary.

16. For these reasons, the staff suggests adding the following new paragraph 17A(c)

17A(c) there are no indicators that the state actually participated in those financial and operating policy decisions of either entity that had a direct effect on transactions between those entities in the periods covered by the financial statements.

17. This wording is similar to the recommended wording for influence between the transacting entities, but it differs in one respect:

(a) The recommended wording for influence by the state is limited to actual influence that **directly** affected the transactions between the transacting entities.

(b) The recommended wording for influence between the transacting parties includes actual participation by one party in the key operating and financial decisions of the other party. That includes indirect influence of the sort discussed in paragraph 15(b) (influence on a decision to build a factory used to manufacture products sold to both related and unrelated parties). In that example, suppose that one party both (i) directly influences the other party's decision to build the factory and (ii) subsequently, without exerting further influence, buys some of the product made in that factory. In that case, there is a closer link between the parties than if the influence on the decision to build the factory comes from a state that controls both transacting parties.

Materiality

18. Consider a transaction on non arms' length terms between two entities controlled by the same state. Applying the Board's tentative decisions in October, the exemption would not apply, so both entities would have to disclose all transactions between them.

19. Arguably, this result is disproportionate if the transaction on non arms' length terms is insignificant and there are thousands of other transactions between the same entities, all on arms' length terms. Some may feel that normal materiality considerations could prevent such a result. However, this may not be the case in this context. There is a multiplier effect: a transaction on non arms' length terms that is otherwise immaterial to the financial statements could trigger disclosure of all transactions with the same counterparty. Materiality would, presumably, depend on the materiality of all those transactions, not on the materiality of the transaction that triggers the disclosure.

20. Consequently, materiality may not apply to a decision of this sort in the same way as for other decisions about recognition, measurement and disclosure. Is it possible or desirable to develop specific guidance to explain how materiality might apply in this context? In the staff's view, it is not. Therefore, the staff looked for another way to assess whether disclosures about transaction with related state-controlled entities provide sufficient benefits to users to justify a requirement to disclose those transactions. As already noted, the underlying notion is that parties are related if one participates in financial and operating policy decisions of the other. If a transaction occurs on non arms' length terms, that fact would not always show conclusively that one of the transacting parties (or the state) actually participates in the financial and operating policy decisions of the other party. Therefore, the staff recommends that:

    (a) the existence of transactions on non arms' length terms should not automatically block the exemption for all transactions with that counterparty. Instead, transactions on non arms' length terms should be an indicator that one transacting party actually participated in the financial and operating policy decisions of the other, but should not be viewed as definitive proof that such participation occurred.

(b) All indicators should have equal status:

   (i) Transactions on non arms' length terms (paragraph 17B(a) of the ED)

   (ii) The entities share resources (paragraph 17B(b) of the ED)

   (iii) The entities engage in economically significant transactions with each other (paragraph 17B(c) of the ED)

   (iv) Direction or compulsion by the state, or the presence of common board members (paragraph 17C of the ED)

   (v) Other indicators, not listed specifically in the ED (paragraph 17D of the ED)

21. The staff believes that the approach suggested in the previous paragraph has the following benefits for entities within the scope of the proposed amendments:

(a) It avoids reliance on normal materiality judgements in a context where they may not function as well as in many other contexts.

(b) If a related party influences a single small transaction but does not participate in financial and operating decisions, neither party would need to disclose all transactions with the other party. Thus, related party disclosures would focus on cases where significant influence may have affected an entity's financial position, financial performance or cash flows.

(c) A state-controlled entity would not need to carry out an exhaustive, and perhaps burdensome, search of all transactions with entities controlled by the same state to determine whether at least one transaction on non arms' length terms occurred. Instead, the entity could search for indicators of influence over financial and operating decisions.

Volume of disclosure in some markets

22. In some countries, many entities are state-controlled. In these cases, a single transaction on non arms' length terms could require an entity to disclose a very large number of transactions with the same counterparty, even if every other transaction with that counterparty is on arms' length terms. Some have suggested that this could impose a heavy burden on preparers without necessarily providing users with relevant information.

23. It could be argued that this result is consistent with the spirit of IAS 24, namely that an entity discloses all transactions with related parties, including transactions on arms' length terms. However, the exemption proposed in the ED is based on the view that disclosure should not be required if there is little risk that the related party relationship affected the terms of the transaction.

24. Some have suggested an alternative way to give users relevant information, using the following approach used in China:

   (a) Accounting standards state: "Enterprises are not regarded as related parties simply because they are under common control from the State, if no other related party relationships exist between them."

   (b) The disclosure standards, other regulations and rules promulgated by the securities regulators require companies to disclose unfair transactions or other issues, in "significant events" "special risk" or other parties of annual report, prospectus, current report or other disclosed documents.

25. There are two significant differences between that approach and the approach proposed by the Board:

   (a) In China, state-controlled entities are not regarded as related to each other simply because they are under common control from the State, if no other related party relationships exist between them. In contrast, the Board's approach regards entities controlled by the same state as related parties, but exempts them from most related party disclosure requirements if specified conditions are met (they would still need to disclose a statement that there were no indicators that the reporting entity influenced, or was influenced by, the other entity).

(b) In China, disclosures (mandated by the securities regulator) focus on transactions that relate to significant events or specific risks. In contrast, if the Board's proposed exemption for state-controlled entities does not apply, the Board's approach would require disclosure of all transactions between the entities in question.

26. In relation to (a), the staff believes it is preferable to maintain the Board's position that two entities controlled by the same state are related to each other. Any exemption given would be an exemption from the disclosure requirements rather than a change in the definition.

27. In relation to (b), the following recommendations earlier in this paper would reduce the possibility that a single transaction on non arms' length terms would trigger disclosure of a large number of transactions:

(a) Clarifying that the test for the exemption focuses on actual participation in key operating and financial decisions (paragraph 14).

(b) Making the existence of transactions on non arms' length terms an indicator of such actual participation (as proposed in the ED), rather than a conclusive determinant (as tentatively concluded by the Board in October). (paragraph 20)

28. In the staff's view, if the Board accepts the above recommendations, no further action is needed to deal with possible concerns about the volume of disclosure.

Appendix
Extract from Exposure Draft

17A A reporting entity is exempt from the disclosure requirements of paragraph 17 in relation to an entity if:

(a) the entity is a related party only because the reporting entity is controlled or significantly influenced by a state and the other entity is controlled or significantly influenced by that state; and

(b) there are no indicators that the reporting entity influenced, or was influenced by, that entity.

17B Indicators that the influence referred to in paragraph 17A(b) exists are when the related parties:

(a) transact business at non arms' length rates (otherwise than by way of regulation);

(b) share resources; or

(c) engage in economically significant transactions with each other.

17C The existence of direction or compulsion by a state for related parties to act in a particular way could indicate that the influence referred to in paragraph 17A(b) exists. Furthermore, the presence of common members on the boards of the reporting entity and the other entity could lead to the relationship having an effect on the profit or loss and financial position. Entities shall consider whether the existence of direction or compulsion by a state or the existence of common board members indicates that the influence referred to in paragraph 17A(b) exists.

17D The indicators of influence described in paragraphs 17B and 17C are not exhaustive. A reporting entity might identify other factors or circumstances that suggest the reporting entity could influence, or be influenced by, the related party that would require the reporting entity to comply with the requirements in paragraph 17.

17E When there are no indicators that the reporting entity influenced, or was influenced by, any other entity controlled or significantly influenced by the state, as provided by paragraph 17A, the reporting entity shall disclose a statement to that effect. When a reporting entity does not qualify for the exemption in paragraph 17A it shall comply with all the disclosure requirements of this Standard for that related party.