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

INFORMATION FOR OBSERVERS

Board Meeting:	**18 September 2008, London**
Project:	**Amendments to IAS 24 *Related Party Disclosures***
Subject:	**Redeliberations: Exemption for state-controlled entities (Agenda paper 13B)**

INTRODUCTION

1. In February 2007, the Board published an Exposure Draft (ED) of proposed Amendments to IAS 24 Related Party Disclosures – *State-controlled Entities and the Definition of a related party*. The ED proposed to exempt state-controlled entities from the disclosure requirements in paragraph 17 of IAS 24 (see Section 1 and Appendix A to Agenda paper 13A for further detail).

2. Based on comments received on the ED, the Board redeliberated this proposal and tentatively reached a conclusion on this proposal at its October 2007 meeting. Also, the Board confirmed the conclusion after discussing this proposal again at its January 2008 meeting (see Section 2 and Appendix A to Agenda paper 13A for further detail).

3. However, during the discussions, some Board members and staff questioned whether the proposed exemption (or approach) for state-controlled entities is fully operational (see Section 3 for further detail). This paper reviews this concern and raises alternative proposals.

4. The **purpose of this paper** is to raise alternative approaches to the proposed exemption, and ask the Board to discuss them. If the Board adopts one of those alternative approaches, it would replace the exemption proposed in the ED (ie the indicator approach) and lead to re-exposure. Therefore, discussion of this paper will ultimately determine a direction of this project – i.e. whether to finalise the ED or have re-exposure (see Section 4 for further detail).

5. This paper divides into four sections:
   (a) Section 1: Summary of the ED proposal and comments received
   (b) Section 2: Summary of the Board's tentative decisions after reviewing comments
   (c) Section 3: Review of the revised ED proposal
   (d) Section 4: Detailed discussion of alternative proposals

SECTION 1: SUMMARY OF THE ED PROPOSAL AND COMMENTS RECEIVED

ED proposal[1]

6. The ED proposed an exemption from the disclosure requirements in paragraph 17 of IAS 24 for entities that are controlled or significantly influenced by a common state unless influence exists between those entities. An indicator approach supports this proposed exemption. The specific reasons for this proposal are as follows:
   (a) In jurisdictions where the state controls, or significantly influences, many entities, it can be difficult to identify other entities that are controlled or significantly influenced by the state. Entities that are controlled or significantly influenced by the state might not even be aware that an entity with which they have transactions is a related party.
   (b) The cost of meeting the requirements in IAS 24 for entities controlled or significantly influenced by the state is not always offset by the benefit of increased information for users of financial statements. More specifically:
      (i) extensive disclosures are required for transactions that are unaffected by the relationship;
      (ii) if some entities that are controlled or significantly influenced by the state are not aware that their transactions are with a fellow subsidiary or associate, the disclosures provided will be incomplete; and
      (iii) if transactions are affected by a related party relationship, information about those transactions is potentially useful to users of the financial statements, but might well be obscured by excessive disclosures about unaffected transactions.

[1] See Appendix A to Agenda paper 13A for the full contents of the proposal in the ED.

(c) Some states establish subsidiaries and associates to compete with each other. Moreover, subsidiaries and associates within a state can have different boards of directors with different objectives and goals. In these cases, transactions between such entities are likely to be conducted as if they are unrelated parties.

Comments received

7. Most respondents supported the indicator approach proposed in the ED. However, they suggested clarifying how to apply it. Specific suggestions include:

   (a) clarifying whether the influence referred to in paragraph 17A(b) of the ED refers to the exercise of influence in the overall relationship between state-controlled entities or over the specific transactions concerned;

   (b) when actual influence exists in some transactions undertaken by an entity, clarifying whether the exemption is precluded only for those specific transactions or for all transactions with the state-controlled entity;

   (c) clarifying or defining the term ‘influence’ referred to in paragraph 17A(b) of the ED;

   (d) clarifying whether it is the actual influence or potential influence that precludes the use of the exemption;

   (e) clarifying whether the indicators proposed in paragraph 17B of the ED are rebuttable presumptions or definitive rules;

   (f) extending the exemption to entities jointly controlled by a state;

   (g) including ‘influence by a common state’ to preclude the use of the exemption; and

   (h) clarifying how to apply a statement on use of the exemption as required in paragraph 17E of the ED (see Agenda paper 13C).

Suggestions by respondents that are state-controlled entities

8. We received 11 comment letters (9 from China, 2 from South Africa) from respondents that are state-controlled entities. All the respondents generally supported the proposed exemption and the indicator approach. However, some respondents made the following suggestions:

   (a) exclude state-controlled entities from the definition of a related party (i) unconditionally or (ii) if transactions are fully conformed to the market mechanism;

   (b) provide the exemption for state-controlled entities without any preconditions; and

   (c) view the indicators listed in the paragraph 17B of the ED as rebuttable presumptions *not* definitive rules.

SECTION 2: SUMMARY OF THE BOARD'S TENTATIVE DECISIONS AFTER REVIEWING COMMENTS

Board's tentative decisions (referred to as 'the revised ED proposal'[2])

9. The Board has tentatively decided to clarify that the proposed exemption for state-controlled entities would not be available if either:
   (a) the reporting entity influenced a transaction with that other state-controlled entity, or that entity influenced a transaction with the reporting entity; or
   (b) the reporting entity influenced, i.e. participated in, the operating and financial policy decisions of that other entity, or that entity influenced the operating and financial policy decisions of the reporting entity.

10. For both (a) and (b) in paragraph 9, influence would be sufficient to preclude the use of the exemption. Significant influence, as defined in IAS 24, is not required.

11. Paragraphs 17B and 17C of the ED listed indicators of possible influence by the state. However, after reviewing the comment letters, the Board reached the following tentative conclusions:
   (a) If a transaction occurs on non-arms' length terms (ED 17B(a)), the exemption for state-controlled entities would not be available.
   (b) The remaining indicators proposed in the ED (paragraphs 17B(b) and (c), 17C and 17D) would remain as indicators that there might have been influence, rather than as definitive criteria that influence had been exerted.

12. In addition, the Board tentatively decided to clarify that a transaction is on arms' length terms if the same terms, including price, would have applied if it had taken place between unrelated parties.

[2] For ease of explanation, the staff refers to the ED proposal that reflects the Board's tentative decisions as the revised ED proposal although most of its decisions just clarify the ED proposal.

13. The Board has also reached the following tentative decisions:

(a) 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.

(b) The 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.

(c) The following changes should be made to paragraph 17A of the ED:

(i) to clarify that two entities are not related to each other simply because they are both significantly influenced by the same state; and

(ii) to clarify that the proposed exemption for state-controlled entities would not be available in cases of influence by a common state. The Board also decided not to add guidance on how to identify a common state.

Main changes from the ED proposal

14. The main changes made by the Board to the ED proposal are outlined below:

Item/Proposal	ED proposal	Revised ED proposal
Definition of influence (ED.17A(b))	• Unclear • Items as a definitive criterion below explain this	• Any influence, not limited to significant influence
Influence by a common state (ED.17A)	• Unclear whether it blocks the exemption	• Clarify that it blocks the exemption
Item as a definitive criterion[3] (ED.17B)	• Transact business at non-market rates (otherwise than by way of regulation) • Share resources • Engage in economically significant transactions with each other	• Transact business on non-arms' length terms (otherwise than by way of regulation) • Note: the wording 'at non-market rates' changed to 'on non-arms' length terms'
Item as an indicator[4] (ED.17C–D)	• The existence of direction or compulsion by a state to act in a particular way • The presence of common board members • Other factors identified by the entity	• Share resources[5] • Engage in economically significant transactions with each other[6] • The existence of direction or compulsion by a state to act in a particular way • The presence of common board members • Other factors identified by the entity

[3] An item as a definitive criterion indicates that such influence referred to in the ED.17A was actually exerted.

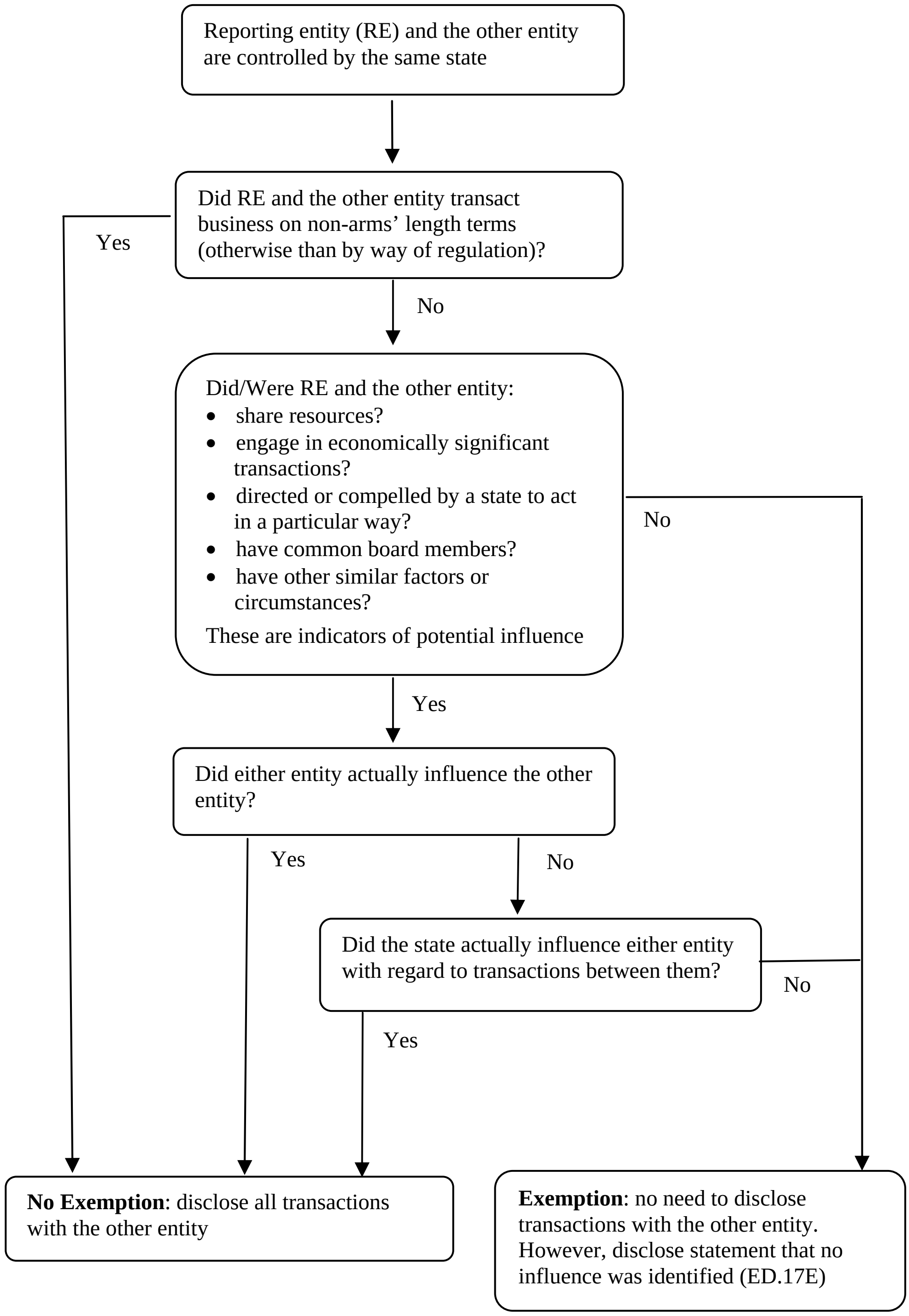
[4] An item as an indicator suggests that such influence referred to in the ED.17A might have occurred and so triggers a further assessment of whether such influence was actually exerted.

[5], [5] For reference, according to the alternative definition of a related party by the IAASB in paragraph 54 of Agenda paper 13D, entities that are under common control by a state (i.e. a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

SECTION 3: REVIEW OF THE REVISED ED PROPOSAL

Flowchart: applying the revised ED proposal

15. This flowchart is intended to help the Board understand the revised ED proposal and show how to apply it.



Review of the revised ED proposal

16. The revised ED proposal generally reflects the following conditions in relation to state-controlled entities and suggestions that respondents made to clarify the ED proposal (see paragraph 7)
    (a) Difficulties in identifying state-controlled entities at all levels.
    (b) Cost-benefit effect of disclosure requirements of transactions between state-controlled entities.
    (c) Actual corporate governance – i.e. many state-controlled entities operate independently of each other like unrelated parties.

17. Therefore, the revised ED proposal is expected to provide some relief for state-controlled entities. However, there have been concerns about whether the revised ED proposal would be fully operational due to its complexity. The staff reviews the revised proposal from the perspective of cost and benefit. Cost is about how easy or complex it is to apply this proposal and benefit is about the usefulness of the information it could provide.

Cost perspective

18. Above all, the revised ED proposal seems very complex to apply. When applying this proposal, a state-controlled reporting entity and its auditor should:
    (a) distinguish between items as a definitive criterion and items as an indicator;
    (b) interpret what each item as a definitive criterion or an indicator means;
    (c) for an item as a definitive criterion, identify all other state-controlled entities that are related and examine all transactions with them to search for at least one transaction that belongs to this item;
    (d) on the other hand, for an item as an indicator, assess whether any influence was actually exercised by either entity or the state once this item is identified; and
    (e) according to the result of the examination or assessment in (c) and (d), either disclose all transactions with other state-controlled entities or disclose a statement that no influence was identified.

19. For (a) and (b) in paragraph 18, it may be very difficult for both prepares and auditors to interpret and apply each item as a definitive criterion or an indicator although it may not be so to distinguish items into a definitive criterion and an indicator. Many comments received on the ED support this. In this context, it could be a matter of judgement in most cases to apply the indicator approach and thus many contradictory results in judgement may happen between a reporting entity and the other entity.

20. For (c) in paragraph 18, the item 'transact business on non-arms' length terms' is treated as a definitive criterion that influence had been exerted. A materiality notion is not considered for this. Under this decision, only one transaction on non-arms' length terms will preclude the use of the exemption. Above all, it may be very hard to judge in practice whether a transaction between state-controlled entities is on arms' length terms or not. Also, a transaction on non-arms' length terms may exist because of different reasons in various and complex situations. If such one transaction automatically blocks the exemption, the exemption would not apply in most cases. Again, this decision would cause a state-controlled reporting entity or its auditor to identify all other state-controlled entities that are related and examine all transactions with them to search for at least one transaction on non-arms' length terms. This means that the exemption may not achieve the Board's intention.

21. For (d) in paragraph 18, items such as share resources and engage in economically significant transactions with each other may be pervasive in a state-controlled environment. In many cases, this could lead to an assessment about whether any influence was exercised by either entity or the state.

22. In addition, the term 'influence' to block the exemption means any influence, not limited to significant influence. Under this decision, the exemption is not available if either party or the state just influences the transaction, regardless of what sort of influence it is. There may exist different sorts of influence between state-controlled entities by either party or the state. For example, influence of the sort that exists between related parties (i.e. significant influence), normal influence of unrelated parties or one off minor influence by the state not through participation in policy decisions. If all these sorts of

influence block the exemption, the exemption would not apply in most cases. This also means that the exemption may not achieve the Board's intention.

23. For (e) in paragraph 18, a state-controlled reporting entity should disclose all transactions with the other state-controlled entity if a transaction on non-arms' length terms is identified or any influence was exercised by either entity or the state. It could be a big burden for the reporting entity to identify and disclose all transactions with the other entity. This could also impose a huge burden on its auditor.

Benefit perspective

24. In addition to the concerns from a cost perspective as outlined above, it is questionable whether the revised proposal could provide useful information to users of financial statements for the following reasons:

(a) A transaction on non-arms' length terms or any influence may be common in a state-controlled environment. Either factor would block the exemption. Therefore, excessive disclosures may still be made about unaffected transactions and this will obscure affected transactions that are potentially useful.

(b) If a significant portion of the reporting entity's transactions are with other state-controlled entities, it may not be useful to require detailed disclosure of them.

(c) Due to its complexity in application (eg difficulties in identifying all other state-controlled entities), information that the revised proposal provides may still be incomplete.

SECTION 4: DETAILED DISCUSSION OF ALTERNATIVE PROPOSALS

Possible alternative proposals

25. The staff considers three possible alternative proposals below to relieve concerns about the revised ED proposal. Under each alternative, like the ED, state-controlled entities are treated as related parties to each other but exempted from disclosure requirements of relationships and transactions between them. Each alternative requires a simple disclosure statement, instead of detailed disclosure, unlike the ED. Each alternative proposal would require re-exposure if it is accepted by the Board.

Alternative proposal 1: simple disclosure statement for all state-controlled entities in a certain country

26. This alternative notes that related party relationships and related party transactions, between state-controlled entities, are pervasive in some countries such as China, as compared to other countries. It may not be so useful to disclose related party transactions in detail in such countries.

27. Therefore, this alternative suggests that all state-controlled reporting entities in a certain country where state ownership is pervasive should unconditionally make only such a simple disclosure as follows:

> [Example] The (describe the governmental entity) owns x% of the company's outstanding shares and a significant proportion of its activities take place in (country). Governmental ownership is pervasive in (country), and a significant portion of the company's transactions takes place with entities that are also owned, in whole or in part, by the governmental entity. Those transactions are related party transactions as defined in IAS 24, *Related Party Disclosures*. As permitted by IAS 24, the related party disclosures in paragraph X do not include disclosure about those related parties.

28. To briefly compare Alternative proposal 1 with the revised ED proposal:

Item	**Revised ED proposal**	**Alternative proposal 1**
Contents	Indicator approach (indicators and criteria)	Simple disclosure statement
Key notion	Actual influence	Pervasive state ownership
Subject of exemption	On an entity level (all state-controlled entities (SCEs) in every country)	On a country level (all SCEs in a country)
Scope of exemption	Limited to SCEs uninfluenced	All SCEs, influenced or uninfluenced
Implied view of SCEs in some countries	They operate differently from non-SCEs under common control	They are even more pervasive than in any other countries, rather than being operated differently from non-SCEs
Application / effectiveness	(likely to be) More complex / less effective	(likely to be) Less complex / more effective
Re-exposure	Not required	Required

29. However, there are some possible problems with this alternative proposal:

(a) If accepted by the Board, this would require re-exposure.

(b) Defining *pervasive* state ownership may be difficult. A qualitative test seems more appropriate than a numerical test. One approach might be to model the definition on *impracticable*[7] as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(c) This comes very close to being a country-specific exemption.

(d) Some may request for extending the exemption to situations other than state ownership. For example, the complaints about the relevance of information might be equally true of related party disclosures in the statements of a subsidiary or affiliate that is not controlled by a state.

---

7 Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

Alternative proposal 2: simple disclosure statement for all state-controlled entities having pervasive transactions with other state-controlled entities

30. This alternative is generally based on ideas in Alternative proposal 1 but focuses on an entity rather than a country. That is, this notes that if a state-controlled reporting entity transacts pervasively with other state-controlled entities, detailed disclosure of transactions with them that the reporting entity makes may not be useful enough to justify cost, regardless of which country the entity is located in.

31. Therefore, this alternative suggests that if it has pervasive transactions with other state-controlled entities, a state-controlled reporting entity in every country needs to make only such a simple disclosure as follows:

> [Example] The (describe the governmental entity) owns x% of the company's outstanding shares. A significant portion of the company's transactions takes place with entities that are also owned, in whole or in part, by the governmental entity. Those transactions are related party transactions as defined in IAS 24, *Related Party Disclosures*. As permitted by IAS 24, the related party disclosures in paragraph X do not include disclosure about those related parties.

32. However, all the possible problems but (c) in paragraph 29 above are also true of this alternative.

Alternative proposal 3: simple disclosure statement for all state-controlled entities (pervasive condition not needed)

33. This alternative notes the following points:
    - (a) It may not be useful or practicable to disclose transactions between state-controlled entities in detail if they are pervasive.
    - (b) It may not be useful to disclose them in detail if they are normally conducted on arms' length terms, whether transactions between state-controlled entities are pervasive or not. IAS 24 implies in places that related party transactions are more likely to be affected by the relationship.
    - (c) Defining the term *pervasive* may be not impossible but very difficult.

34. Therefore, this alternative suggests that, regardless of whether it has pervasive transactions with other state-controlled entities, a state-controlled reporting entity in every needs to make only such a simple disclosure as follows:

> [Example] The (describe the governmental entity) owns x% of the company's outstanding shares. Some of the company's transactions take place with entities that are also owned, in whole or in part, by the governmental entity. Those transactions are related party transactions as defined in IAS 24, *Related Party Disclosures*. As permitted by IAS 24, the related party disclosures in paragraph X do not include disclosure about those related parties.

35. However, this alternative in effect reverts to a blanket exemption[8] that existed in IAS 24 before 2004 even though this could avoid most possible problems expected in Alternative proposals 1 and 2.

Summary of three alternative proposals

36. To summarise the three alternative proposals raised above:

<table>
<tr><th>Item</th><th>Alternative proposal 1</th><th>Alternative proposal 2</th><th>Alternative proposal 3</th></tr>
<tr><td>Similarities</td><td colspan="3">• Like the ED, state-controlled entities treated as related parties to each other, but exempted from disclosure requirements of relationships and transactions between them
• Require a simple disclosure statement (different in contents), instead of detailed disclosure
• Require re-exposure</td></tr>
<tr><td>Key condition</td><td>Pervasive state ownership</td><td>Pervasive transactions</td><td>Pervasive condition not required</td></tr>
<tr><td>Who will be exempted?</td><td>All SCEs in a country where state ownership is pervasive</td><td>SCEs in every country that have pervasive transactions with other SCEs</td><td>All SCEs in every country without any condition</td></tr>
</table>

[8] No disclosure of transactions is required in financial statements of state-controlled enterprises of transactions with other state-controlled enterprises (paragraph 4(d) of IAS 24 (reformatted 1994)). The Improvement Project deleted this exemption from 2004 because at the time the Board concluded that the disclosure requirements would not be a burden for state-controlled entities.

Questions for the Board

37. The staff recommends that the Board should pursue an alternative proposal rather than finalising the revised ED proposal. As reviewed in Section 3, the revised ED proposal seems very complex and is still likely to create such a big compliance cost exceeding benefits from information disclosed.

38. However, the following points needs to be considered again for pursuing an alternative proposal:

(a) Board time and staff resources should be considered.

(b) No relief will be given to preparers until a final standard is ready.

(c) It is necessary to decide how to handle a new definition of related parties in a re-exposure draft (see paragraphs 41-44 below)

39. ***Does the Board agree with the staff's recommendation in paragraph 37?***

40. In addition, if the Board agrees to pursue an alternative proposal, the staff recommends Alternative proposal 3 above, noting items listed in paragraph 33. ***Does the Board agree?***

Additional issue: definition of a related party

41. The ED also proposed the revised definition of a related party. Respondents generally saw the proposal as an improvement, but there still remain some inconsistencies to discuss, which are addressed in Agenda paper 13D.

42. If the Board agrees to pursue an alternative proposal, it may then consider how to handle the following in a re-exposure draft:
   (a) The definition of a related party revised through the ED and the Board's redeliberations.
   (b) Inconsistencies, if any, that the Board may wish to fix with re-exposure after discussion of Agenda paper 13D.

43. Possible approaches to handle items listed in paragraph 42 include:

Approach 1: Re-exposure of the revised definition *not* for comments, but re-exposure for comments on the fixes for the inconsistencies discussed in Agenda paper 13D

Approach 2: Re-exposure of only the revised definition *not* for comments but for completeness of a re-exposure draft, thus the inconsistencies discussed in Agenda paper 13D will not be fixed through this project

Approach 3: No re-exposure of both the revised definition and the inconsistencies discussed in Agenda paper 13D. In this approach, the inconsistencies will not be fixed through this project, and the revised definition will either be finalised separately from re-exposure or will wait until re-exposure ends

44. Because this issue depends on discussion of Agenda paper 13D in addition to this paper, the staff will ask the Board questions about this in Agenda paper 13F after discussing Agenda papers 13D and 13E.