Project **Annual Improvements – 2009–2011 cycle**

Topic **IAS 24 *Related Party Disclosures* – Key Management Personnel**

Introduction

1. This paper discusses a request asking to clarify the required disclosures in accordance with IAS 24 *Related Party Disclosures* in cases where a reporting entity hires key management services from a separate management entity.

2. The issue arises from concern over divergent disclosures and the submission asked for the issue to be addressed through *Annual Improvements*.

Purpose of this paper

3. The purpose of this paper is to ask the Board whether it approves an annual improvement to the definition of a related party in IAS 24. This proposal would clarify what disclosure is appropriate in the situation where key management services are provided by a separate management entity.

4. This paper:

   (a) provides background information and explains the issue;

   (b) makes a recommendation for

      (i) a proposed amendment to IAS 24 as presented in Appendix A,

(ii) an assessment of the proposed amendment against the criteria for inclusion in *Annual Improvements*;

(c) asks the Board whether they agree with the recommendation.

Background information

5. The submission presents the case of mutual funds that do not have employees and therefore hire 'key management' services from a separate management entity. Further in this paper and for ease of reference, the 'mutual fund' will be referred to as the **'reporting entity'** and the entity providing management personnel as the **'management entity'**.

6. In some jurisdictions, the management entity would typically perform the role of the trustee and of the manager. Management duties would usually comprise:

   (a) administrative services, such as processing distributions to unit holders, management the unit holders register and preparing the financial statements;

   (b) investment management services, such as buying and selling investment assets; and

   (c) 'key management' services relating to planning and directing the activities of the mutual fund.

   As remuneration for the services performed, a service fee is paid by the reporting entity to the management entity. Both the management entity itself and employees or directors of the management entity may provide services to several reporting entities.

7. An analysis of the services provided by the management entity, the power it holds in respect of the reporting entity and the benefits that the management entity receives from the reporting entity will lead to one of the following assessments of the relationship between the management entity and the reporting entity:

(a) the management entity controls or jointly controls the reporting entity;

(b) the management entity does not control or jointly control but has significant influence over the reporting entity; or

(c) the management entity does not control, jointly control or have significant influence over the reporting entity.

8. In the staff's view, when paragraph 6(a) or paragraph 6(b) applies, the management entity is a related party of the reporting entity, based on the definitions in IAS 24 paragraph 9(b). Information about the relationship and transactions between the reporting entity and the management entity must be disclosed in accordance with IAS 24.

9. This paper does not address whether or not the management entity is a related party as a result of having control, joint control or significant influence. Instead, this paper is focused on what related party disclosures may or may not be required as a consequence of KMP services being provided.

10. As a result, this agenda paper is written on the assumption that the situation in paragraph 7(c) above applies.

11. In addition, there is an underlying presumption in the submission that KMP services may be provided by another entity (in this case, the management entity) and that the employees of that other entity who provide those services may qualify as KMP of the reporting entity. The staff agrees with that underlying presumption.

12. Lastly, the staff noted from outreach activities performed on the issue that a key indicator of performance for mutual funds in some jurisdictions is the 'management expense' ratio, which is a ratio of total expenses charged to the mutual fund by its management entity over the fair value of total assets.

13. At the IFRS Interpretations Committee meeting in September 2010, the Interpretations Committee agreed with the staff proposal to recommend that the Board add this issue to the 2009–2011 *Annual Improvements* cycle[1].

Issues raised

14. Two questions were asked in the context of the submission:
    (a) Can key management personnel (KMP) as defined in IAS 24 include an entity as opposed to individuals? and
    (b) Should the reporting entity disclose:
        (i) the remuneration paid by the management entity to the individuals providing the KMP services, or
        (ii) the service fees paid by the reporting entity to the management entity for the KMP services?

Staff analysis

Can KMP definition include entities as well as individuals?

15. The staff notes that the KMP definition in paragraph 9 of IAS 24 refers specifically to 'persons'. In addition, the limited review to IAS 24 published in November 2009 amended the definition of a related party in paragraph 9 of IAS 24. The amendment resulted in a clear distinction between 'a person' and 'an entity'.

16. Therefore the staff believes that the intent is that the KMP definition refers to individuals as opposed to an entity.

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[1] The Committee recommends that the Board should amend, within *Annual Improvements*, the definition of a related party in IAS 24 to clarify that a management entity that provides KMP services to a reporting entity is deemed to be identified as the relevant related party in respect of those KMP services. Consequently, the service fees paid by the reporting entity to the management entity would be disclosed. The Committee also recommends that the individuals who are employees or directors of the management entity and are acting as KMP of the reporting entity should not be identified as a related party (unless they qualify as related parties for other reasons). The revised definition would apply to the management entity's parent, its subsidiaries and fellow subsidiaries.

Are disclosures for KMP relevant in the context of the submission?

17. The staff acknowledges that two views exist currently as to disclosing KMP compensation as defined in paragraph 9 of IAS 24:

    (a) View A: the reporting entity should disclose KMP compensation paid by the management entity to its employees or directors acting as KMP of the reporting entity even though the reporting entity has no employees.

    (b) View B: the reporting entity should not be required to disclose compensation for individuals that are not its employees or directors. The reporting entity should only be required to disclose the service fee it pays to the management entity for the KMP services provided.

18. Under view A, because the individuals who provide key management services to the reporting entity are assessed as KMP - in accordance with the definition set out in paragraph 9 of IAS 24 - the reporting entity should apply paragraph 17 of IAS 24. This paragraph specifically requires the disclosure of KMP compensation.

19. However, the reporting entity may not have access to the employee compensation information required to make this disclosure. Even if the information is available, practical difficulties arise when it comes to disclosing employee benefits for an employee of the management entity who services several funds.

20. Proponents of view B argue that paragraph 17 of IAS 24 is not applicable to the situations described in the submission because the amounts are not paid to the reporting entity's own employees.

21. The staff believes that the intent in the definition is to describe compensation as being amounts paid by the entity to its own employees and directors. Therefore the staff is of the opinion that the reporting entity should not be required to disclose amounts paid by the management entity to its employees or directors. Compensation paid to the employees or directors of the management entity does not represent relevant information for the purpose of applying IAS 24.

Related party transactions disclosures and their interaction with KMP identified as a related party in the context of the submission

22. The staff is aware that identifying the individuals of the management entity providing the KMP services as the related party because they act as KMP of the reporting entity may lead to a counter intuitive conclusion. Paragraph 18 of IAS 24 requires disclosure of related party transactions as defined in paragraph 9:

> *A related party transaction* is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

23. In the absence of payment directly from the reporting entity to the employees or directors of the management entity acting as KMP of the reporting entity, some argue that no information needs be disclosed with respect to the related party transaction between both the management and the reporting entities.

24. The staff thinks that the service fee paid reflects the related party transaction between the management entity and the reporting entity, therefore the staff disagrees with the outcome outlined above.

25. The staff is concerned that following a conclusion where no disclosure is required may lead to important information being omitted. Therefore the staff believes that the individuals from the management entity acting as KMP of the reporting entity should not be identified as the relevant related party in the specific situation described in the submission.

Need for identifying another related party in lieu of KMP?

26. Given the above analysis, the staff is of the opinion that the reporting entity should be required to capture its transactions with respect to the key management services provided and should be required to disclose the related amounts other than compensation paid by the management entity to its employees or directors.

27. If the individuals acting as KMP of the reporting entity are not to be identified as the relevant related party, the staff suggests that the management entity itself be identified as the relevant related party in the specific fact pattern of the

submission. The staff believes this is a simple solution to ensure that the service fee paid by the reporting entity to the management entity is captured as the related party transaction.

28. The staff believes this outcome is consistent with the intent in disclosing related party transactions in accordance with IAS 24.

CEO engaged by contract

29. An additional issue was raised at the Interpretations Committee meeting in September 2010. It related to situations where a reporting entity engages an individual as its CEO, by contract, when no entity is involved. The concern was whether the proposed changes to the definition of a related party in IAS 24 would exclude such a CEO from being identified as a related party.

30. The staff noted that the proposed change intends to exclude from KMP disclosure requirements only those entities and their employees or directors that provide KMP services to a reporting entity that has no employees. The staff believes that the proposed amendment does not change the disclosure requirements in IAS 24 in the specific situation of a CEO engaged by contract when no entity is involved. In the staff's opinion, such a CEO would meet the definition of KMP and the first sentence of subparagraph 9(a)(iii) would apply.

Recommendation

31. The staff is of the opinion that IAS 24 should specify that a management entity that provides KMP services to a reporting entity is a related party. This could be done by adding a subparagraph to paragraph 9(b) of IAS 24.

32. As a consequence of this change, the staff believes that the reporting entity should not apply paragraph 17 of IAS 24 on disclosures of employee benefits but rather paragraph 18 of IAS 24. The reporting entity would then disclose the <u>service fee</u> paid to the management entity among other information about transactions with the management entity.

33. In addition, the staff considered whether the revised definition of a related party should only apply to the management entity or also to its parent, subsidiaries and fellow subsidiaries. Because the management entity could cause the reporting entity to enter into transactions with the management entity's parent or subsidiaries, the staff believes that the parent, subsidiaries and fellow subsidiaries of the management entity should also be identified as related parties of the reporting entity. Therefore the reporting entity would also be required to disclose transactions with other members of the management entity's group.

34. The amendment would therefore be to clarify that:

    (a) a management entity that provides KMP services to a reporting entity is deemed to be identified as the relevant related party in respect of those KMP services;

    (b) the parent of the management entity and its subsidiaries and fellow subsidiaries are also related parties of the reporting entity; and

    (c) the individuals who are employees of the management entity and are acting as KMP of the reporting entity are not to be identified as a related party (unless they qualify for other reasons).

35. The proposed amendment wording is included in Appendix A.

Annual Improvements criteria assessment

Assessment against current criteria

36. The existing criteria for deciding of the inclusion in the 2009-2011 *Annual Improvements* cycle are that the change is non-urgent and necessary.

37. The staff notes that amending IAS 24 as proposed in paragraph 32 above would reduce diversity without introducing a new principle. It would also address the practicability issue of allocating relevant employee benefits to the reporting entity in cases where the employees manage several mutual funds.

38. The staff assesses the proposed amendment as being non-urgent but necessary. Therefore it meets the current criteria for inclusion in the *Annual Improvements* cycle for 2009-2011.

Assessment against the proposed new criteria

39. The IFRS Foundation has exposed for public comments proposed enhanced criteria as part of an amendment to the Due Process Handbook. The comment period ends 30 November 2010.

40. The staff proposes an assessment of the inclusion of the issue against the proposed enhanced criteria reproduced in full below:

    (a) The proposed amendment has one or both of the following characteristics:

        (i) clarifying—the proposed amendment would improve IFRSs by:

        - clarifying unclear wording in existing IFRSs, or
        - providing guidance where an absence of guidance is causing concern.

        A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

(ii) correcting—the proposed amendment would improve IFRSs by:

- resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or
- addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.

(b) The proposed amendment has a narrow and well-defined purpose, ie the consequences of the proposed change have been considered sufficiently and identified.

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach agreement on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a pressing need to make the amendment sooner than the project would.

41. In the staff's opinion, the issue satisfies the above proposed *Annual Improvements* criteria:

(a) In the staff's opinion, the change proposed is a clarification which intends to clarify the appropriate disclosure relating to KMP services in the situation described. The proposed change does not introduce a new principle or amend an existing principle. It provides clarification in accordance with existing principles of IAS 24.

(b) In the staff's opinion, the proposed change is limited to disclosures in well-defined situations where the reporting entity has no employees and hires key management personnel services from a separate entity.

(c) The staff thinks that since the Interpretations Committee reached a conclusion on a timely basis on the issue, it is likely that the Board will also reach a conclusion on a timely basis.

(d) There is no current or planned Board project to review IAS 24.

Transition provisions

42. The staff is of the opinion that transition provisions should follow the general principles in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and entities should apply the amendment retrospectively.

Consequential amendments

43. The staff reviewed the proposed change in relation to other existing IFRSs. The staff did not identify consequential amendments to other standards.

44. Specifically, the staff believes no consequential amendment is needed to IFRS 1 *First-Time Adoption of International Financial Reporting Standards*.

Questions to the Board

45. The Interpretations Committee discussed this issue and agreed to recommend that the Board should include this issue in the *Annual Improvements* 2009-2011 cycle.

Question 1 – Committee recommendation on the need for the amendment
Does the Board agree with the Interpretations Committee recommendation to amend IAS 24 as proposed in paragraph 32?

Question 2 – Staff assessment of the proposed amendment against the criteria for inclusion in the *Annual Improvements*
Does the Board agree with the inclusion of the proposed amendment to IAS 24 in the *Annual Improvements* cycle for 2009-2011?

Question 3 – Wording for the proposed amendment
Does the Board agree with the wording for the proposed amendment as set out in Appendix A?

Appendix A - Draft amendment to IAS 24 *Related Party Disclosures*

This appendix includes drafting of the proposed amendment. It is based on the text included in the most recently issued standards (including the *Improvements to IFRSs* issued in May 2010). New text is underlined and deleted text is struck through.

Proposed amendment to IAS 24 *Related Party Disclosures*

Paragraph 9 is amended (new text is underlined) and paragraph 29 is added.

Definitions

9 **The following terms are used in this Standard with the meanings specified:**

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

- **(i) has control or joint control over the reporting entity;**
- **(ii) has significant influence over the reporting entity; or**
- **(iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. <u>If the persons providing the key management personnel services to the reporting entity are employees or directors of an entity that is a related party under (b)(viii) then those persons are not key management personnel for the purposes of applying this standard.</u>**

(b) An entity is related to a reporting entity if any of the following conditions applies:

- **(i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).**
- **(ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).**
- **(iii) Both entities are joint ventures of the same third party.**
- **(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.**
- **(v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.**
- **(vi) The entity is controlled or jointly controlled by a person identified in (a).**
- **(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).**
- **(viii) <u>The entity, or members of its group, provides key management personnel services to the reporting entity.</u>**

Effective date and transition

29 *Improvements to IFRSs* issued in [date] amended paragraph 9. An entity shall apply this amendment for annual periods beginning on or after 1 January 2012. Earlier application is permitted.

Basis for Conclusions on proposed amendment to IAS 24 *Related Party Disclosures*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Definition

BC1 Constituents pointed out that divergence exists in the disclosures of related party transactions identified when a management entity provides key management personnel services to a reporting entity. The divergence is that some reporting entities would disclose the compensation paid by the management entity to its employees or directors acting as key management personnel of the reporting entity. Other reporting entities disclose the service fee paid by the reporting entity to the management entity with respect to the key management personnel services rendered.

BC2 The Board noted that IAS 24 *Related Party Disclosures* is unclear as to what information to disclose with respect to key management personnel when those persons are not employees of the reporting entity. To address the diversity in disclosures that arises from IAS 24 being unclear, the Board proposes to amend the definition of a related party. The amendment would clarify that a management entity that provides key management services to a reporting entity is deemed to be the related party rather than the persons that are the key management personnel. As a result of the change, the reporting entity would be required to disclose the service fee paid to the management entity that employs or has as directors the persons that provide the key management services, and would not be required to disclose compensation to those persons. In addition, because the management entity can cause the reporting entity to enter into related party relationships with the management entity's parent or its subsidiaries, the Board proposes that the parent, subsidiaries and fellow subsidiaries of the management entity be also identified as related parties of the reporting entity.