

XX June 2007

Amendment to IAS 24 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER
Comments should be sent to Commentletter@efrag.org by
24 May 2007

Dear Sir/Madam,

Re: IASB Exposure Draft of Proposed Amendments to IAS 24 *Related Party Disclosures: State-controlled Entities and the Definition of a Related Party*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB Exposure Draft of Proposed Amendments to IAS 24 *Related Party Disclosures: State-controlled Entities and the Definition of a Related Party*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The ED proposes to amend IAS 24 *Related Party Disclosures*:

- to eliminate some disclosure requirements that would otherwise apply to entities that are controlled or significantly influenced by a state in relation to transactions with other entities that are controlled or significantly influenced by that state. The exemption does not apply when influence exists in such relationships; and
- to tidy up some of the definitions in the standard and in particular to amend the definition of a related party to eliminate certain inconsistencies and generally to make the definition easier to understand and apply.

We welcome the IASB's initiative. The disclosure requirements that the ED is proposing to amend are currently proving burdensome and resulting in disclosures that appear to be of little value, and the definition of related party is in need of improvement and simplification. Our detailed comments are set out in the appendix to this letter.

If you would like further clarification of the points raised in this letter, Paul Ebling or I would be happy to discuss these further with you.

Yours sincerely,
Stig Enevoldsen
EFRAG, Chairman

Appendix

Question 1 – State-controlled entities

(a) Do you agree with the proposal to provide, in the circumstances described in this exposure draft, an exemption for entities controlled or significantly influenced by the state? If not, why? What would you propose instead and why?

- 1 We agree that, when two entities are related only because they are both controlled/significantly influenced by the state, the disclosures required by paragraph 17 of IAS 24 can be both extremely onerous and not particularly useful if the reporting entity is not actually influenced by, or does not actually influence, the other entity. We therefore support the proposal.
- 2 Having said that, we are not convinced that there are any circumstances in which the benefits that arise from the disclosures required by paragraph 17 will be significant enough to justify the cost of producing them. For that reason, we wonder whether the IASB should consider extending the scope of the exemption proposed in this exposure draft so that the principle on which it is based—disclosures about transactions between related parties need to be given only if one or other party is under the influence of the other—is the general principle rather than just the principle that should be applied when the existing principle—disclosures about transactions between related parties need to be given whenever a related party relationship exists, even if neither party is under the influence of the other—is onerous to apply. We think this change:
 - would make the standard more robust and more principle-based, because there would be no need for an exception from a principle, and
 - would mean that the principle underlying paragraph 17 would be more in line with the stated objective of IAS 24 as set out in paragraph 1 of the standard.
- 3 Such a change could perhaps be supported by a requirement for entities to state that related party transactions not disclosed were undertaken on terms equivalent to those prevailing in arms length transactions.
- 4 We also have some more detailed comments about the exemption proposed:
 - (a) The ED proposes that the exemption should apply when both related parties are related parties only because they are *controlled* or *significantly influenced* by a state. However, the Basis does not explain why the exemption is not available when *joint control* by a state is involved. We think either it should explain the omission or the exemption should be extended to joint control.
 - (b) The ED proposes that the exemption will not be available if the indications are that the reporting entity influenced or was influenced by the other entity. However, we would have thought that in many cases it will be the state—rather than one of the entities—that will influence one or both of the entities. Thus, under the standard as amended, a state could 'force' an entity to do something not listed in paragraph 17B in relation to a related party and the exemption would still be available. Putting aside practical considerations for a moment, is that what the IASB intends?

One possibility might be to amend paragraph 17A(b) as follows: "there are no indicators that the reporting entity influenced, or was influenced by, that entity or that the state influenced either party". The difficulty with this though is that it would automatically exclude associates from the exemption, and in any case it might not be apparent to the reporting entity whether the state has influenced the counterparty.

- (c) We wondered whether it might be possible to read paragraph 13 as being inconsistent with the proposed exemption from the requirements of paragraph 17. Paragraph 12 talks clearly about parent-subsidiary relationships, but paragraph 13 talks more vaguely about related party relationships where "control exists" and could perhaps therefore be read as applying to relationships that would fall within the proposed exemption. We believe that if a relationship falls within paragraph 17A, it should not be required to provide the paragraph 12 and 13 disclosures.

(b) Do you agree:

- (i) **that an indicator approach is an appropriate method for identifying when the exemption should be provided for entities controlled or significantly influenced by the state; and**
- (ii) **that the proposed indicators are appropriate?**

If not, why? What would you propose instead and why?

- 5 We agree in principle with the adoption of an "indicator approach", but have some difficulty with the actual indicators in proposed new paragraph 17B. Our problem is that the indicators set out in that paragraph do not seem to be based on a clear underlying principle, and as a result it is difficult to see what the paragraph is trying to get at. For example, it is not clear to us why the existence of "economically significant transactions" undertaken between two parties that are related should necessarily mean that one of the parties is influencing the other. Similarly, there are a number of arrangements nowadays in which two entities might "share resources", so it is not clear why that should necessarily be an indication that one related party influences the other. One way of addressing these concerns would be to try to articulate more effectively what the underlying principle is; for example, are we looking for influence in respect of a transaction or influence more at the entity-level? An alternative might be to adopt an approach similar to that adopted in IAS 36; in other words to describe the indicators as indicators that influence may (ie not will) exist.

Question 2 – Definition of a *related party*

(a) The definition of a related party in IAS 24 does not include, for a subsidiary's individual or separate financial statements, an associate of the subsidiary's controlling investor. The Board has decided that it should be included, and thus proposes to amend the definition of a related party. The Board similarly proposes that when the investor is a person, entities that are either significantly influenced or controlled by that person are to be treated as related to each other. Do you agree with this proposed amendment? If not, why? What would you propose instead and why?

- 6 EFRAG agrees with both these proposals. The existing definition is clearly inconsistent in treating a subsidiary of an investor and that investor's associate as related parties only if the reporting entity is the investor's associate. It is also

inconsistent in treating the relationship between a subsidiary of an investor and that investor's associate differently depending on whether the investor is an entity or an individual. We agree that a subsidiary of an investor and that investor's associate are related parties of each other (i) regardless of whether it is the associate or the subsidiary that is the reporting entity and (ii) regardless of whether the investor is an entity or an individual.

(b) IAS 24 does not define associates of an entity as related parties. However, when a person has significant influence over an entity and a close member of the family of that person has significant influence over another entity, IAS 24 defines those two entities as related parties. The Board proposes to align the definition for both types of ownership by excluding from the definition of a related party an entity that is significantly influenced by a person and an entity that is significantly influenced by a close member of the family of that person. Do you agree with the proposed amendment? If not, why? What would you propose instead and why?

- 7 Under the existing definition, an entity's associates are not considered to be related parties of each other, yet an entity that is significantly influenced by a person and another entity that is significantly influenced by a close family member of that person are related parties. Again, we agree that this is inconsistent. We also agree that the appropriate way to deal with the inconsistency is to change the definition so that an entity that is significantly influenced by a person and another entity that is significantly influenced by a close family member of that person are no longer related parties.

(c) IAS 24 defines any entity over which a member of the key management personnel of the reporting entity has control, joint control or significant influence, or in which the member holds significant voting power, as related to the reporting entity. However, the converse is not true. Thus, when the entity that a person controls, jointly controls or significantly influences, or in which the person has significant voting power, is the reporting entity and that person is a member of the key management personnel of another entity, that other entity is not defined as related to the reporting entity. The Board proposes to remove this inconsistency by expanding the definition to encompass both situations. Do you agree with the proposed amendment? If not, why? What would you propose instead and why?

- 8 Currently, when a member of the key management team of the reporting entity controls, jointly controls or significantly influences a second entity, the entities are treated as related when the first entity is the reporting entity, but not when the second entity is the reporting entity. We agree that this is inconsistent. We further agree with the proposal to amend the definition so that they are treated as related parties regardless of which of the entities is the reporting entity.

(d) Do you agree with the proposal to clarify the definition of a related party? Does the wording proposed capture the same set of related parties as IAS 24 at present (except for the amendments described in (a)–(c) above)? Do you agree that the proposed wording improves the definition of a related party? If not, why? What would you propose instead and why?

- 9 We agree that the existing definition is complex and difficult to understand and apply. We further agree that the changes and restructuring the IASB is proposing will improve the definition. However, we think the revised definition is also complex and will prove difficult to understand and apply.
- 10 For example, we think the revised definition continues to contain inconsistencies. Assume that Entity A is a post-employment benefit plan for the benefit of employees

of either Entity B or an entity (Entity C) related to Entity B. Under paragraph (b)(iv) of the definition, Entity A will be a related party of Entity B. However, Entity B does not appear to be a related party of Entity A. Or, to take another example, according to (b)(vi), if a man is a member of the key management personnel of Entity D and his wife has significant influence over Entity E, then Entity E is a related party of Entity D if Entity D is the reporting entity. However, if Entity E is the reporting entity, Entity D does not appear to be a related party of Entity E. If this is right, the definition remains flawed. And if it is not right, our error shows the definition is still too difficult to understand.

- 11 For that reason we suggest that further efforts are made to simplify the definition and, in doing so, bring out the underlying principles.

For example, one of our members has suggested that it might be possible to restructure the definition so that it reads something like the following:

- (a) An entity or a person is a related party of the reporting entity if the direct relationship between the two involves significant influence or a control relationship
- (b) If the entity or person referred to in (a) and the reporting entity have only an indirect relationship, they are still related parties if that relationship is a control relationship.
- (c) Any entity or person related to an entity or person referred to in (a) or (b) through a direct or indirect control relationship person is also a related party of the reporting entity.

A control relationship is a relationship in which either one party controls (jointly or on its own) an entity or one party is a member of the key management personnel of an entity.

If entity A is a related party of entity B, it follows that entity B is a related party of entity A.

This definition is not quite right yet, but it does show how the definition could perhaps be simplified and restructured.

Question 3 – Definition of related party transactions: Do you agree with the proposal to clarify the definition of a related party transaction? If not, why? What changes would you propose and why?

- 12 We have no problem with the proposed change to the definition of a related party transaction.

Question 4: Do you have any other comments on the proposals?

- 13 We are concerned about one of the changes proposed to the definition of 'close members of the family'. The proposed change we are concerned about is the one highlighted below:

<p>Close members of the family of person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity <u>and</u>. They may include:</p> <ul style="list-style-type: none">(a) that person's domestic partner (such as a husband or wife or equivalent) and children;(b) children of that person's domestic partner; and(c) dependants of that person or that person's domestic partner.

On the one hand, we recognise that there are practical difficulties in applying the unamended definition because it is not realistic to expect an entity to be able to form a judgement as to whether one family member “may be expected to influence, or be influenced by” another family member. As a result, entities inevitably have to apply broad rules of thumb. The amendment highlighted above seems to us to be an attempt to incorporate just such a rule of thumb into the definition (ie a person is influenced by or influences their partner, their or that partner’s children, and their or that partner’s other dependents).

On the other hand, although the effect of the proposed change is to bring all the persons listed in (a)-(c) within the definition regardless of whether they may be expected to influence, or be influenced by, that person in their dealings with the entity:

- (a) we are not sure that was the intention (because if it was the intention the words “may be expected to influence, or be influenced by, that person in their dealings with the entity” would be redundant); and
- (b) we think it would be extremely difficult to comply with such a requirement, because it is not realistic to expect entities to have this amount of information about the private lives and private affairs of individuals. In many cases the reporting entity will need to rely on the co-operation of others to obtain the information it needs to provide the disclosures, and in some cases that could involve privacy infringement. Amending the requirement to include a 'best efforts/best endeavours' clause would help to address this concern.

We therefore believe a rethink is needed.

- 14 Paragraphs 9 and 11A explain that ‘a state’ is a national, regional or local government, and the term is being used to refer to any governing jurisdiction that has statutory or regulatory powers of government. Judging by the position in Europe, a number of different structures are used to control (or influence) entities that are in effect state-controlled (or state-influenced) entities. We are worried that not all those structures will result in those entities being called state-controlled or state-influenced under the definitions in the ED. For example, in some countries the entities are not controlled or influenced by the government directly, but by an agency that is neither strictly speaking a governmental body nor a private sector body. We think such entities should fall within the scope of the exemption proposed in the ED but are not sure that they do.

We therefore suggest adding words along the following lines at the end of new paragraph 11A: “For the purposes of this standard’s references to an entity that is controlled or significantly influenced by a state, bodies that are in effect an organ of the state that be treated as part of that state.”