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30 Cannon Street
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Exposure Draft of Proposed Amendments to IAS 24 Related Party Disclosures: State-controlled Entities and the Definition of a Related Party

Dear Ms. Pope,

We are pleased to comment on the Exposure Draft of Proposed Amendments to IAS 24 *Related Party Disclosures: State-controlled Entities and the Definition of a Related Party* (referred to as 'the ED' or 'the proposed amendments'). Our responses to the questions raised in the ED are set out in the Appendix to this letter.

The ED addresses a very real practical issue for jurisdictions where state-controlled and state-influenced entities play a major role. We have previously sent an agenda submission to the IFRIC raising our concerns regarding whether compliance by such entities with the disclosure requirements of the current version of IAS 24 is achievable in certain jurisdictions. In general, we are supportive of the approach proposed in the ED for easing the disclosure burden for entities controlled or significantly influenced by the state.

Similarly, we are pleased to see the Board addressing a number of inconsistencies in the definition of a related party and proposing to improve the wording in the Standard. We believe that the proposals would improve the definition, but that it is still unclear and difficult to understand in places. We also find the wording in many areas of the revised Standard somewhat ambiguous and so, in some cases, we are forced to deduce the intentions of the Standard, rather than being able to understand the words used. We believe that the lack of clarity could cause significant problems to readers if English is not their first language and also when the Standard is translated into other languages.

Although we have noted some significant reservations with the ED, we feel that the IASB is heading in the right direction. If the Board focuses on developing the key points, e.g. the definition of "state" and the application of the indicators of influence, and also works to clarify the language of the Standard, then we are optimistic that it will result in an improvement in disclosures made under the Standard.

If you have any questions concerning our comments, please contact Ken Wild in London on +44 (0) 207 007 0907.

Yours sincerely

Ken Wild

Global IFRS Leader

Appendix A

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?

In principle, we are supportive of the exemption proposed in the ED. We agree that the exemption should not be available for transactions between the reporting entity and other entities controlled or under significant influence by the same state where there are indicators of influence in the relationship.

We agree with the Board (as stated in BC12 of the ED) that the cost of meeting the disclosures in paragraph 17 of IAS 24 for entities controlled or significantly influenced by the state is not always offset by the benefit of the increased information. The proposed exemption would allow the entities to avoid disclosing significant amounts of information that is of little value, and that could otherwise distract the user's attention from related party relationships that do have an impact on the financial statements.

However, we do have some concern over the clarity of the wording in the ED. It is unclear whether the influence referred to (for example in paragraph 17A(b) of the ED) refers to the exercise of influence over the specific transactions under consideration, or in the overall relationship between the parties. We believe that the intention is to refer to the overall relationship, rather than whether the specific transactions have been affected by such influence – but that intention is not clear from the current wording. We believe that there is a risk that varying interpretations will lead to divergence in practice and we suggest that an additional paragraph be introduced to follow 17A so as to make the intentions of the Board clear.

Similarly, we feel the Board should state clearly in the ED that the exemption only applies to horizontal transactions (i.e., transactions between two entities controlled or significantly influenced by the same state). Currently, we believe that the exemption in the ED could be interpreted as also applying to vertical transactions (i.e., transactions between the state and an entity that it has control or significantly influence over).

State-owned versus state-controlled entities

Currently the exemption in the ED covers relationships between entities controlled and significantly influenced by the state and it exempts those relationships between entities where influence does not exist. However, this results in an unusual outcome as we appear to have a scenario where we are exempting entities controlled (or significantly influenced) by the state, because the state doesn't really influence their operations. In China, the common term for such entities is state-owned entities. State-owned entities may or may not meet the definition of a related party. We wonder if the Standard should instead be referring to state-owned entities (rather than state-controlled entities) to focus on this scope and avoid the rather strange outcome above, or at least make some connection to the term state-owned entities within the Standard.

Level of state

We believe that clarification is also required regarding the level of state that is to be considered for the purposes of the exemption, for instance when we're dealing with federal systems of government, such as in Australia and Canada. We're uncertain whether transactions between entities controlled or influenced by different levels of government would be considered to be related. We suggest that the IASB adds the necessary clarity by focussing on a more robust definition of "state" and this would also remove the necessity for the supporting paragraph 11A.

Level of disclosure in 17E

Where an entity qualifies for the exemption in paragraph 17A, it is unclear what needs to be disclosed under paragraph 17E, i.e. whether this requires a simple generic sentence such as "certain transactions with other entities controlled or significantly influenced by the state have not been disclosed" or whether it requires more detail for instance "The entity entered into transactions with Entity A, which is controlled by Government X, during the period, but has not disclosed those transactions because ...." In any case, we believe that the requirement to provide such a statement implies that the entity is able to identify all the entities controlled or significantly influenced by the state which are related parties. However, the board concluded in BC 11 that "*In jurisdictions with a large number of state-controlled entities, or entities over which the state has significant influence, 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".* If the Board includes a requirement for such a statement, it should provide clarity over what is expected and we suggest that this would specify that a generic statement is required.

Drafting issues for paragraph 17A and 17D

We have a number of smaller concerns regarding the drafting of the exemption in paragraph 17A and one concern regarding paragraph 17D. We are concerned about the following issues:

- Currently, we are concerned that paragraph 17A(b) may appear only to capture the case where one entity influences the other entity, without considering influence directly applied by the state. For example, we feel we would want to capture the following case - If the state instructs reporting entity A (which it owns) to have a preferential treatment of entity B (which the state also owns), although it is not B itself that has influence over A, we believe it would be appropriate to have related party disclosures for the transactions between A and B. Furthermore, we feel this necessary clarity may best be added via additional guidance in paragraph 17C. We are concerned that a quick fix to amend the wording in 17A(b) e.g., adding "influenced by that entity or that state", may exclude from the exemption not only our example provided above, but all cases where the state has influence in one or both entities (e.g. This may also exclude from the exemption the case where the reporting entity was influenced by one level (or body) of the state and the other entity was influenced by a different level (or body) of the state).
- We interpret the terms "controlled" and "significantly influenced" by reference to IAS 27 and IAS 28, respectively. We believe that paragraph 17A(a) should also address the notion of joint control as defined in IAS 31.

- The proposed wording in paragraph 17A(a) could lead to confusion as it suggests that two associates of the state are related parties (under common significant influence by the state) even though they would not meet the definition of a related party. A note could be added to remove this confusion, such as "Two entities would not be related parties under IAS 24 simply because they are under common significant influence by the state".
- Paragraph 17D states "*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*." This paragraph seems to refer to the potential to influence, whereas 17A(b) seems to refer to the actual exercise of influence. We feel the wording in 17D should be drafted consistently with paragraph 17A.

(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?

We agree with the approach of having indicators to assist preparers in determining whether the exemption applies. However, we are unclear whether the indicators should be considered in the context of the specific transactions under consideration, or in the overall relationship between entities. As stated under Question 1(a) above, this point needs to be clarified.

We feel that if the IASB proceeds with the proposal to include the indicators in 17B, then certain indicators should be given more weight than other indicators and additional clarification of the meaning of indicators should be given, including how to apply the indicators. For example, what are shared resources? Additionally, whilst we agree that the existence of the indicators listed in paragraph 17B may lead to the conclusion that the reporting entity influences, or is influenced by another entity, we do not believe that this will always be the case. For example, as regards the indicators in 17B(b) or (c), we believe that it is possible for entities to "*share resources*" or "*engage in economically significant transactions with each other*" without the parties influencing each other. For example, consider the circumstances in the People's Republic of China (PRC) where many companies are state-owned. All the gas companies in the PRC, whether privately owned or state-owned must purchase gas from state-controlled entities because the gas industry is dominated by two entities, both of which are state-controlled entities. Although there will be economically significant transactions between these two entities and the gas companies (indicator 17B(c)), it is expected that these transactions will be at arm's length and hence there is no suggestion of influence resulting from common control from the state.

Finally, we also have a practical concern regarding the indicator in 17B(a), ("transact business at non-market rates"). In practice it will be difficult to assess, and also to audit, that a transaction is at a "market rate". There is no guidance in the ED to help to apply this indicator. In relation to this matter, in Europe, discussions are in progress with the European Commission in connection with the 4th and 7th Directives amendments, approved in 2006, that require disclosures of related party transactions that are material and have not been conducted under normal market conditions. In practice, identifying and determining whether a transaction is conducted at market conditions is a difficult exercise to perform and to audit.

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?

Yes, we agree.

(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?

Yes, we agree.

(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?

Yes, we agree.

(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?

We broadly agree with the proposed amendments to the definition of a related party to ensure reciprocal disclosures (i.e., as set out in (a) to (c) above) and to remove inconsistencies. Whilst we agree with the proposal to clarify the definition and believe the restructuring has gone some way toward this objective, we remain concerned that the definition is still very complex and difficult to understand and this cannot be remedied solely by including illustrative examples. We feel one or more charts illustrating which parties are related to the reporting entity may assist users, but cannot be a substitute for a well worded definition.

We also have concerns that certain of the proposed changes conflict with the stated objectives of the ED and hence do not capture the same set of related parties as IAS 24 does at present.

Firstly, consider a scenario where a father is not considered a close member of the family of his son, but the son is a close member of the family of the father. Currently under IAS 24, if the son is a member of the key management personnel (KMP) of X he would be a related party of X, but the father would not be as he's not a close family member of the son. However, under paragraph (a)(i) of the proposed definition of a related party in the ED the father would also be a related party of X. This is because (a)(ii) of the revised definition states that "*A person or a close member of the family of that person is related to a reporting entity if either person is a member of the key management personnel of the reporting entity….*" (emphasis added). In our scenario, the son is a close member of the family of the father and so if either the father or the son is a member of KMP of X, both would be considered a related party of X. If this change is made this goes beyond the stated objectives for the ED and would be a change without the appropriate due process. A similar matter arises for (a)(ii) and (a)(iii) in the definition. To resolve this issue we suggest that the wording in (a) is changed to read "*A person or close member of the family of that person is related to a reporting entity if <u>that</u> person:…*"

Secondly, based on our reading of paragraphs (a)(iii), (e) and (f), in combination, of the existing definition of a related party, we understand that if an individual has joint control over the reporting entity (paragraph (a)(iii)) and that person or a close member of the family of that individual (paragraph (e)) controls, jointly controls or significantly influences, or has significant voting power in another entity, then the other entity and the reporting entity will be considered to be related parties (paragraph (f)). We are unable to identify the same relationship from the proposed revised definition in the ED. It seems that the objectives of the ED regarding changing the related party definition regarding associates have been extended to joint ventures, which we would support. However, we feel this should also be clearly identified as a change, for example highlighted in the introduction.

Thirdly, the existing definition refers to direct and indirect relationships, but the revised definition doesn't. We have made a few comments on how we feel the drafting should be addressed below, together with our ideas on how to make improvements in this area.

Indirect control, indirect joint control or indirect significance

We believe the IASB should clarify that it doesn't matter whether control, joint control or significant influence is held directly or indirectly. This could either be in a general paragraph or within each relevant section of the Standard. For instance, in the following paragraphs:

9a (ii) – *has direct or indirect control...*

9a (iii) – *has direct or indirect joint control or significant influence....*

9b (v) – the entity is directly or indirectly controlled by a person identified in (a)

9b (vi) – has direct or indirect joint control or significant influence.

Similarly, it may be beneficial to make clear whether an associate and a joint venture also include subsidiaries of the associate or the joint venture respectively. As a suggestion e.g. paragraph 9b(iii) could be amended as follows: "*the entity is an associate or joint venture of the reporting entity (or of a member of a group of which the reporting entity is a member) or the entity is a subsidiary of an associate or joint venture of the reporting entity (or of a member of a group of which the reporting entity is a member).*" This addition would make it clear which entities are included, rather than needing to assess whether the definition of an associate includes its subsidiaries and the definition of a joint venture includes its subsidiaries.

Reciprocal disclosures

The ED makes a number of changes to ensure there are reciprocal disclosures. We have identified an additional inconsistency which we feel should also be addressed in the ED. Consider a person who is a member of KMP of Subsidiary A's parent company (Parent A). A close family member of that person controls Subsidiary B (via a 75% shareholding through Parent B). Our understanding from reading paragraph 9 of the ED, is that Subsidiary A is not a related party to Subsidiary B. Paragraph 9b(vii) does not mention "*... or a close member of the family of that person*". However, Subsidiary B is related to Subsidiary A according to paragraph 9b(v). In other words, the definition doesn't include the reciprocal. As the ED is intended to remove such inconsistencies we suggest that the wording of paragraph 9 b(vii) is amended, for instance as follows: "*a member of the key management personnel of the entity, or a parent of the entity or a close member of the family of the key management personnel, has control, joint control or significant influence over, or significant voting power in, the reporting entity.*"

Significant voting power

Paragraphs 9b(vi) and (vii) mention "significant influence" as well as "significant voting power". Paragraph 9a(iii) only refers to significant influence. Although this is not a change from the existing definition in IAS 24 we find this inconsistent. Also, "significant voting power" isn't a commonly understood term. We don't feel there is a need to include both "significant influence" and "significant voting power" in paragraphs 9b(vi) and (vii).

Technical corrections

The references to (d) and (f) in paragraph 11(a) of the existing standard should be updated in line with the revised definition of a related party in the ED.

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?

Yes, we agree.

Question 4 – Definition of related party transactions

Do you have any other comments on the proposals?

Interaction with IFRS 3 - common control transaction

We would like the IASB to consider whether the principle in the ED should be used to establish whether transactions involving state-controlled entities should be treated as common control transactions which are exempt from the requirements in IFRS 3. For example, consider the situation where one state-controlled entity acquires another state-controlled entity in an arm's length transaction (i.e., there are no indicators of state influence in the relationship).

Interaction with IFRS 8 – disclosure regarding major customers

Paragraph 34 of IFRS 8 states "*If revenues from transactions with a single external customer amount to 10 per cent or more of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues*". The paragraph goes on to state "*For the purposes of this IFRS, a group of entities known to a reporting entity to be under common control shall be considered a single customer, and a government (national, state, provincial, territorial, local or foreign) and entities known to the reporting entity to be under the control of that government shall be considered a single customer.*

This paragraph would require all listed entities (not just state-controlled entities) to identify whether or not their customers are state-controlled, for the purposes of identifying the percentage of their revenue which arises from these entities. We don't feel it is practicable or useful to deem all state-controlled entities to be a single customer in a jurisdiction with large-scale state ownership, such as the People's Republic of China (PRC). Therefore, we feel the IASB needs to reconsider paragraph 34 of IFRS 8 for the same reasons that it proposes, in this ED, to have an exemption from the disclosure requirements under IAS 24.

Drafting of paragraph 17

We feel that paragraph 17 should commence "*With the exception of transactions falling within the scope of paragraph 17A,…*" so readers are aware that there is an exemption before they've read through all of the detailed disclosure requirements, which may not be relevant.

We also feel the redrafting of the start of paragraph 17 isn't precise, i.e., "*If an entity has related party transactions…..*" An entity doesn't "have" transactions. It "enters into" transactions or it "is a party" to transactions.

Individual financial statements

The term "individual financial statements" is introduced into the scope paragraph of IAS 24 (paragraph 3). This term is also used in a few other standards (for example paragraph 15 of IAS 40 and BC 11 of IFRS 7). However, this term is not defined anywhere.

We understand the term "individual financial statements" to mean financial statements of entities that are neither separate financial statements nor consolidated financial statements, i.e. they are not a parent, but may have associates or interests in jointly controlled entities. However since the purpose of the changes to IAS 24.3 was to remove confusion, we believe it would be helpful if there was a definition for individual financial statements.

In the event of such a change to paragraph 3, the wording of paragraph 4 should also be reconsidered, in particular the term "*an entity's financial statements*". In order to be consistent with the proposed changes to paragraph 3, paragraph 4 could be reworded as: "*Related party transactions and outstanding balances with other entities in a group are disclosed in an entity's individual or separate financial statements*". Furthermore, we don't think the second sentence of this paragraph is correct in respect of transactions between the reporting entity (if the reporting entity prepares consolidated financial statements) and its parent.

Paragraph 12

The ED suggests some changes to the wording of paragraph 12. We don't support the deletion of "*...between these related parties*" in the opening sentence. The key point here is that disclosure of the relationship between two parties is required irrespective of whether there have been any transactions between those parties. This point is not clear under the revised wording.

In addition, in paragraph 12, it should be considered whether the disclosure "*Relationships between parents and subsidiaries shall be disclosed irrespective of whether there have been transactions between those related parties*." is applicable both in the case where a parent is the reporting entity and in the case where a subsidiary is the reporting entity as well as whether this requirement applies both for consolidated financial statements and the separate financial statements

Paragraph 12 should also specify whether the ultimate controlling party only refers to an entity, or whether it includes individuals, as this is not clear in the Standard.

Finally, we find the first sentence of paragraph 12 unclear as it could be read to require a listing of all subsidiaries. This needs to be clarified, as inconsistent interpretations may be reached which would extend the current requirement in IAS 27, to provide a list of significant investments in subsidiaries, which only applies to separate financial statements. We agree paragraph 14 of IAS 24 needs to be deleted, as proposed, as it is incorrect.

Terminology change from individual to person

In the ED there is a proposal to change the term "individual" to "person" throughout the Standard. In certain countries, such as England and the United States a company is covered by the definition of a juristic "person", so using the term in the Standard to cover only individuals may be confusing. This problem could be remedied by including a definition for "person". However, our preference would be to retain the existing terminology in this particular case.

Definition of close members of family

We also have a concern with the proposed amendment to the definition of close member of the family of a person. The existing definition is not exhaustive but provides examples of those parties who may be considered to be influenced by, or who may influence, the individual. We believe the term "may" should remain in the definition because the effect of its deletion would be to assume that all persons listed in (a) to (c) of the definition influence, or are influenced by, that person in their dealings with the entity. This may not always be the case, e.g. whilst an adult is still likely to be considered their parent's child they will not always be influenced by, or influence, their parent's dealings, even more so if they no longer live in a house together.

We also believe that it would be helpful if the Board clarified the meaning of "domestic" in part (b) of the definition, as is currently used in the reference to "domestic partner" and the meaning of "dependents" in part (c).

Commitments to do something

Paragraph 20(j) of the ED proposes to add a requirement to disclose "*transactions or commitments to do something if a particular event occurs or does not occur in the future*". We would like to understand the rationale for this disclosure, as it is not clear what it means or what it is meant to cover. No due process appears to have taken place for this and it goes beyond the stated objectives of the ED. We would prefer paragraph 20(j) to be deleted. However, if it is included the meaning should be clarified, in particular a commitment "to do something" is rather vague. One solution to this would be for information to be limited to the information currently required under IAS 1.105 for "unrecognised contractual commitments". It's also not clear why there is a requirement that "a *particular event occurs or does not occur in the future*". An entity may have a commitment that is not related to the occurrence of a particular event."

Illustrative examples

We suggest adding joint ventures to example 1 in the Illustrative Examples and highlighting which amounts would be disclosed in the consolidated financial statements under IAS 24 if the group uses the proportional consolidation method or the equity method to account for its investments in the joint ventures.

We don't support the inclusion of Example 2 in the Illustrative Examples as currently drafted. We feel it only covers part of the issue of identifying the KMP of the group (e.g. it doesn't explain how we identify which subsidiaries are significant where the KMP are employees of a subsidiary).

Disclosure requirements

We understand that the IASB is not seeking comments on IAS 24 matters other than those set out in the ED. However, we would like to highlight one area where we feel minor complimentary changes would improve the existing disclosure requirements. Since the Board is revising the definition of a related party we feel that it should also consider the categories for related party disclosures in paragraph 18. Based on experience, the current categorisation for disclosures in IAS 24 is not very useful to users of the financial statements. In particular, it seems that users do not understand why transactions with parties having control over the reporting entity should not be disclosed separately. Under paragraph 18 the existing Standard only requires transactions with a parent (which we understand to be a parent company) to be disclosed separately. If an individual has control over the entity, transactions between that individual and the entity are disclosed in the category in IAS 24.18(g) called "other related parties."

We recommend that the categories are divided up in a more logical way to make them more beneficial to users of the financial statements. For example, one group could consist of parties having control over the reporting entity, including close members of the family where the controlling party is a person, and any entities that are controlled by one of the parent entities, a controlling person or a close family member of that person. Another group might consist of the key management personnel of the entity and of its parent entities, close members of the family of the key management and entities controlled by the key management personnel and their close family members. The current category in 18 (b) "entities with joint control or significant influence over the entity" could be extended with persons and close members of their family with joint control or significant influence over the reporting entity and any entities that are controlled by those persons. The remaining categories could remain unchanged as current paragraph 18 (c), (d), (e), and (g).

We also recommend that paragraph 18 should include some guidelines for cases where a related party is a member of more than one category, e.g. if a person has control over the reporting entity and is a member of the key management personnel. Our recommendation is that transactions with the related party should be included in the category that is mentioned as the first in paragraph 18. That is if a party belongs both to category (b) and (f) transactions with that party should be included in category (b).