

# The Auditing Practices Board

Independent Regulation of the Accountancy Profession

7 August 2002

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Dear David

## **Proposals to improve IAS 24 Related Party Disclosures**

The Auditing Practices Board (APB) welcomes the opportunity to comment on the IASB's proposals to improve IAS 24 'Related Party Disclosures'.

As you are aware, in the United Kingdom and Ireland the Accounting Standard on related party transactions (FRS 8) was introduced in 1995 following a number of corporate scandals where related party transactions had been used either as a means to produce misleading financial statements or to perpetrate fraud. Many of the recent corporate collapses such as Enron, Adelphia, Worldcom and Tyco feature related party transactions and provide compelling evidence that related party disclosure standards need to be considerably strengthened.

There are many similarities between the requirements of FRS 8 and the proposal to improve IAS 24. The APB welcomes this. However, we are strongly of the view that the approach proposed for IAS 24 is overly focused on rules and matters of bookkeeping and insufficiently focused on the principles underlying the need to disclose related party transactions and control relationships. We are also concerned that the 'rules' provided in the proposed revision of IAS 24 provide many opportunities for abuse.

The contrast between the two approaches can be clearly seen by comparing their stated objectives (see Appendix 4). The objective of FRS 8 is high level and principled whereas the proposed objective for IAS 24 is low level, focusing on compliance with rules without explaining why the rules are important.

Another area of particular concern to the APB is the adequacy of the disclosure requirements of control relationships. The UK Accounting Standards Board has proposed that additional requirements be inserted in the version of IAS 24 to be applied in the UK and Ireland. (see Appendix 3.). We fully support the stance adopted by the ASB and believe that their requirements provide for more comprehensive disclosure of control relationships that are more likely to meet public expectations than the IASB's proposal which we consider to be unsatisfactory.

Adequate disclosure of related party transactions and control relationships is considered by the APB to be a fundamental aspect of the true and fair view. As you were reported to have remarked in 1995, when FRS 8 was published, 'it is not enough to look at the puppets: users need to see the strings and know who is pulling them'.

We commend to the IASB much of the approach adopted in FRS 8 and urge the IASB to amend its proposals as follows:

- to include paragraphs 13A and 13B of FRED 25 relating to control disclosures (see Appendix 3)
- to require disclosure of the name of the transacting related party where separate disclosure of the transaction is required by the Accounting Standard;
- to replace the proposed objective paragraph in the Standard with one that is more principled along the lines of the objective paragraph of FRS 8 (see Appendix 4);
- to restructure the definition of a related party along the lines used in FRS 8 (see Appendix 5);
- to make the disclosure requirements within the Accounting Standard consistent with the definition of related party used in the Standard;
- to include the expression 'at any time during the financial period' within the definition of a related party;
- to replace the expression 'significant influence' with 'influence';
- to specify more qualitative disclosures in paragraph 14 of the Exposure Draft; and
- to remove the proposed exemption for management compensation.

In Appendix 1 of this letter we elaborate on the bullet points set out above. In Appendix 2 we respond to the two questions posed in the Exposure Draft.

I would be happy to meet with you to explain the APB's concerns in more detail

Yours sincerely



WID Plaistowe  
Chairman

## ***Significant concerns of the APB with respect to the proposals to improve IAS 24***

### **Disclosure of control**

Where an entity is controlled by another party, FRS 8 requires disclosure of:

- the related party relationship;
- the name of that party and, if different, that of the ultimate controlling party; and
- if the controlling party or ultimate controlling party is not known, disclosure of that fact.

By contrast the IASB proposes the removal of the existing requirement in IAS 24 to disclose related party relationships where control exists and replacing it with the disclosure of relationships between parents and subsidiaries.

The APB believes that it is in the public interest for the name of the controlling party/ultimate controlling party to be disclosed. Consequently, the APB supports the additional paragraphs 13A and 13B (see appendix 3) which the UK ASB has proposed be added to the IAS for use in the UK and Ireland.

The APB notes that paragraph 117 of IAS 1 (revised) proposes disclosure of the name of the parent and the ultimate parent of the group. However, as a parent is defined (in the IASB Glossary) in terms of being an enterprise it excludes control exercised by, for example, individuals and organisations such as trusts. The APB takes the view that paragraph 13A of FRED 25 provides for more comprehensive disclosure of control relationships and therefore will be more likely to meet public expectations than the IASB's proposal.

### **Disclosure of the names of related parties**

As stated above the APB believes that the name of the controlling party, and if different the name of the ultimate controlling party, should be disclosed in the financial statements. However, it is less clear whether it is necessary for the names of transacting related parties to be disclosed. Arguably knowledge of the nature of the relationship with the related party and the effect of related party transactions provides more decision useful information to users of financial statements than knowledge of the name of the related party.

The UK FRS 8 requires the names of transacting related parties to be disclosed but makes exemption for naming related parties where confidentiality is legitimised by law. FRS 8 also recognises that it may be desirable to aggregate the disclosure of similar transactions by type of related party.

The proposed IAS (at paragraph 15), by contrast, does not require the naming of related parties but disclosure of related party transactions for each of the following categories of related party:

- the parent;
- entities with joint control or significant influence over the entity;

- subsidiaries;
- associates;
- joint ventures in which the entity is a venturer;
- key management personnel of the entities or its parent; and
- other related parties.

At paragraph 18 the IAS also permits the aggregation of items of a similar nature except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

Although the APB accepts that it may not be necessary for the names of transacting related parties to be disclosed it is nevertheless of the view that the name of the transacting related party should be disclosed in those circumstances where separate disclosure of the transaction is required by the IAS.

Knowing the name of a related party is of benefit to users of financial statements insofar as it enables them to cross refer to the financial statements and other sources of information issued by the related party. This is acknowledged in the UK FRS 5 *Reporting the substance of transactions* which states ‘...in assessing the commercial effect of a transaction, it will be important to consider the position of all the parties to it, including their apparent expectations and motives for agreeing to its various terms.’<sup>1</sup>

### **The objective paragraph**

The objective of FRS 8 set out in paragraph 1 is a much more high level and principled objective than the proposed objective of IAS 24 (see appendix 4). The APB recommends that an objective paragraph more along the lines of that in FRS 8 replace the proposed objective which focuses too much on compliance with rules without explaining why the rules are important.

### **The definition of a related party**

Although the definition of a related party proposed for IAS 24 is broadly similar to the definition in FRS 8 we recommend that the definition be structured more along the lines of that in FRS 8. The IAS definition is a list of related parties or situations that give rise to a related party relationship, which excludes, for example, shadow directors<sup>2</sup> and persons acting in concert. By contrast, in FRS 8 the principles underlying what constitutes a related party relationship are set out (See appendix 5). This is followed by various lists providing examples of related party relationships. These lists conclude with the caveat that they are not intended to be exhaustive.

We believe that the approach in FRS 8 is superior to the approach proposed for IAS 24 because it establishes high level principles and is consequently not open to abuse through preparers asserting that disclosure of a particular relationship is not required because such a relationship does not fall within any of the specific categories in the proposed Standard.

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<sup>1</sup> See paragraphs 51 and 52 of FRS5

<sup>2</sup> The expression shadow director is defined in UK Company law as ‘a as ‘a person in accordance with whose directions or instructions the directors of the company are accustomed to act’.

The disclosure categories in paragraph 15 of the proposed revision to IAS 24 are not fully aligned with the categories of related party outlined in the definition in paragraph 8. We recommend that the disclosure requirements be made consistent with the definition.

The proposed definition of related party omits to include the expression ‘at any time during the financial period’ and is consequently open to abuse to the extent that preparers may contend that disclosure is only required of transactions with those parties that were related at the year end date.

### **Use of the term significant influence**

The definition of related party includes ‘an interest in the entity that gives it significant influence over the entity’. Significant influence is defined as ‘the power to participate in the financial and operating policy decisions of an economic activity [including] but not [limited to] control or joint control over those policies’. The APB recommends that the expression ‘significant influence’ be replaced with the expression ‘influence’; which is the expression used in FRS 8. The term significant influence is used in the context of defining associated companies and we are of the view that the concept needs to be broader. The explanation of influence set out in paragraph 2.5(a) (iii) and (iv) of FRS 8 (see Appendix 5) provides a useful model of how the term might be explained.

### **The need to specify more qualitative disclosures**

The second sentence of paragraph 14 of the Exposure Draft which purports to set out the minimum disclosures focuses on the quantitative aspects of related party transactions but not the qualitative aspects. We believe that this is a major deficiency in the proposed requirements of IAS 24. We recommend that:

- the words ‘at a minimum’ be deleted. Such wording is generally inappropriate for a bold letter paragraph and as drafted a number of disclosures contemplated in the first sentence would seem to be negated by not being included in the minimum disclosures; and
- adding to the list in the second sentence:
  - (a) the nature of the related party relationship and
  - (b) any other elements of the transaction necessary for an understanding of the financial statements. (A guidance paragraph along the lines of paragraph 22 in FRS 8 would usefully support this bold letter requirement). (See appendix 6).

### **The proposed exemption for management compensation**

The APB does not support such an exemption because it would be too readily open to abuse. Key management personnel are related parties of an entity and the principle underpinning the proposals to revise IAS 24 is that transactions with related parties should be disclosed. Exempting disclosure of management compensation in the ordinary course of an entity’s operation begs the question of what is meant by ‘ordinary course of an entity’s operation’. It may be difficult for auditors to argue that specific transactions with management were other than in the ordinary course of an entity’s operations. The recent disclosures concerning how directors were remunerated at Tyco and Adelphia illustrate the breadth of imagination that can be applied in these matters.

Establishing a precedent for exemption based on transactions carried out “in the ordinary course of an entity’s operations” could be a slippery slope leading to calls for exemption of all sorts of related party transactions. This approach to related party transactions was mooted in the UK in the late 1980’s but did not win support.

***Questions for respondents posed by IASB in Exposure Draft of revisions to IAS 24***

Question No.	Question	Suggested Response
IASB (i)	<p>Do you agree that the Standard should not require disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations (see paragraph 2)?</p> <p>“Management” and “compensation” would need to be defined, and measurement requirements for management compensation would need to be developed, if disclosure of these items were to be required. If commentators disagree with the Board's proposal, the Board would welcome suggestions on how to define “management” and</p>	<p>The APB does not support such an exemption because it would be too readily open to abuse. Key management personnel are related parties of an entity and the principle underpinning the requirements in the IAS is that transactions with related parties should be disclosed. Exempting disclosure of management compensation in the ordinary course of an entity's operation begs the question of what is meant by ‘ordinary course of an entity's operation’. It may be difficult for auditors to argue that transactions with management were other than in the ordinary course of an entity's operations.</p> <p>Establishing a disclosure criteria of “in the ordinary course of an entity's operations” could be a slippery slope to exemption of all sorts of related party transactions. Again “ordinary course of an entity's operation” would need to be defined. This approach to related party transactions was attempted in the UK in the late 1980's and was not supported.</p> <p>We do not consider these concerns to be warranted as the need for definition applies equally if the transactions are to be exempted from disclosure.</p>

	“compensation”.	
IASB (ii)	Do you agree that the Standard should not require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a wholly owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs (see paragraph 3)	The APB does not support the proposed exemption and believes that related party disclosures should be required in the separate financial statements of a parent or wholly owned subsidiary that are published with the group’s consolidated financial statements. The APB supports the reasoning of the six members of IASB who expressed a dissenting view (to the exposure draft’s proposals) on this issue. However the APB would limit such disclosure to those transactions that have not been eliminated on consolidation.



**Additional paragraphs proposed by UK ASB with respect to control**

13A When the reporting entity is controlled by another party, there should be disclosure of the related party relationship and the name of that party and, if different, that of the ultimate controlling party. If the controlling party or ultimate controlling party of the reporting entity is not known that fact should be disclosed. This information should be disclosed irrespective of whether any transactions have taken place between the controlling parties and the reporting entity.

13B If the reporting entity is controlled by another party, that fact is relevant information, irrespective of whether transactions have taken place with that party, because the control relationship prevents the reporting entity from being independent. Indeed, the existence and identity of the controlling party may sometimes be at least as relevant in appraising an entity's prospects as are the performance and financial position presented in its financial statements. The controlling party may establish the entity's credit standing, determine the source and price of its raw materials, determine the products it sells, to whom and at what price, and may affect the source, calibre and even the primary concern and allegiance of its management.

**The objective paragraph from FRS 8**

The objective of this FRS is to ensure that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them.

**The proposed objective paragraph for IAS 24**

The objective of this Standard is to prescribe the disclosure of information about related party relationships and about transactions and outstanding balances between an entity and its related parties.

**Definition of related parties in FRS 8**

2.5 (a) Two or more parties are related parties when at any time during the financial period:

- (i) one party has direct or indirect control of the other party; or
  - (ii) the parties are subject to common control from the same source; or
  - (iii) one party has influence over the financial and operating policies of the other party to an extent that that other party might be inhibited from pursuing at all times its own separate interests; or
  - (iv) the parties, in entering a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests;
- (b) For the avoidance of doubt the following are related parties of the reporting entity  
.....
- (c) and the following are presumed to be related parties of the reporting entity unless it can be demonstrated that neither party has influenced the financial and operating policies of the other in such a way as to inhibit the pursuit of separate interests.....
- (d) ...the following are also presumed to be...

Sub paragraphs (b), (c) and (d) are not intended to be an exhaustive list of related parties.

**Guidance dealing with disclosure of other elements of the transaction**

Paragraph 14 (x) requires disclosure of ‘any other element of the [related party] transactions necessary for an understanding of the financial statements’. An example falling within this requirement would be the need to give an indication that the transfer of a major asset has taken place at an amount materially different from that obtainable on normal commercial terms.