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Accounting Standards Committee of Germany ®
Der Standardisierungsrat

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Dear David,

Exposure Draft 'Relationships with the State – Proposed amendments to IAS 24'

We appreciate the opportunity to respond to the International Accounting Standards Board's Exposure Draft (ED) 'Relationships with the State – Proposed amendments to IAS 24'. This letter represents the view of the German Accounting Standards Board (GASB).

Although we generally support the IASB's objective to exempt state-controlled entities from the disclosure requirements of IAS 24.17, we would like to make the IASB aware of major concerns to be considered in the context of your proposals. Outlined in the appendix you will find an alternate proposal to structure an exemption from the disclosure requirements of IAS 24.17 considering these concerns.

From a consistency perspective we agree with the Board's proposals for an improved definition of related parties by a general restructuring and by deleting inconsistencies. However, guidance needs to be provided as to how the term 'significant voting power' shall be defined. In addition, we still have major concerns with the definition as far as it incorporates 'significant influence', i.e. associated parties.

Based on the foregoing concerns, we would like to make a more far-reaching proposal to amend IAS 24, i.e. to limit related party relationships in substance to those related parties having 'control' and 'joint control'.

Although we understand that the Board has completed its discussion of the other amendments previously proposed in the first exposure draft, published in February 2007, we have outlined some concerns with regard to these other amendments.

For detailed comments we refer to the appendix to this comment letter.

If you want to discuss any aspects of this letter in more detail, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

APPENDIX

Question 1 - State-controlled entities
This exposure draft proposes an exemption from disclosures in IAS 24 for entities controlled, jointly controlled or significantly influenced by the state in specified circumstances. Do you agree with the proposed exemption, and with the disclosures that entities must provide when the exemption applies? Why or why not? If not, what would you propose instead and why?

We generally agree with the proposed exemption and with the disclosures that entities must provide when the exemption applies. However, we would like to outline below the following issues which should be considered by the IASB:

1) The proposed exemption does not satisfactorily address the main underlying issue state-controlled entities are frequently facing, which is the often existing impracticality or even inability identifying other state-controlled entities. Therefore, if other state-controlled entities can not be identified, it will also not be possible to comply with the disclosure requirements as laid out in ED-IAS 24.17B (b) as illustrated in the example No. 1 - IE3. Even the qualitative or limited quantitative descriptions outlined in this example require a reasonably complete identification of relevant state-controlled entities. In BC11 of the ED it is noted that the main difficulty for a state-controlled reporting entity would be ‘to identify every state-controlled entity’. However, the reporting entity may not even be in a position to identify any state-controlled entities being a related party.

2) We understand that based on para. 17A of the ED a reporting entity is allowed to use the exemption from the disclosure requirements of IAS 24.17 with respect to transactions between the state or other state-controlled entities, even if this reporting entity is able (without undue cost and effort) to fully comply with IAS 24.17 in this respect. Since we consider this information to be meaningful for the user of the financial statements we consider the proposed approach to be too wide.

3) The exemption as proposed by the IASB would equally apply to instances where, in a vertical group structure, a state controls, jointly controls or significantly influences entities **directly or indirectly** – we consider this approach also to be too wide. We would favour an approach according to which the exemption would

be applicable if the only reason for the two entities being related is that they are **directly** controlled, jointly controlled or significantly influenced by the same state. Referencing to the illustrative example 1 of the ED, from Entity A's perspective the exemption would not apply to transactions Entity A has made with Entity 1 and Entity B. This is because related party relationships exist between all entities of the subgroup of Entity 1 irrespective of the fact that the state is the ultimate parent.

4) Further, we are of the opinion that the difficulty of identifying related parties or to obtain necessary information from these parties is not an issue pertaining solely to state-controlled entities. These issues can be evident for all related party environments (specifically complex group structures and related party relationships involving persons (individuals) – in particular when related parties are determined based on 'significant influence' or 'significant voting power').

Considering these issues and concerns, we propose to structure the exemption as follows:

Alternative:

In a **first step** a reporting entity must identify their related parties.

In a **second step** the reporting entity shall be required to make a qualitative statement

- whether it has been able to identify all its related parties and
- whether transactions have been made with such identified related parties

with a 'best endeavours clause'. According to this clause the disclosures comprising the qualitative statement will not be required if the reporting entity, despite using its best endeavours, is unable to obtain the necessary information (however, applying the 'best endeavours clause' would need to be disclosed).

In a **third step** a reporting entity shall be required to quantify in accordance with IAS 24.17 the information underlying the qualitative statement made as per second step, also with a relevant 'best endeavours clause'.

All the requirements (according to steps 1, 2 and 3) would need to be met, irrespective of the nature of the related parties (eg whether state-controlled entities are involved or not).

Further, compared with the ED amend IAS 24 (February 2007), the definition of state-controlled entities proposed in IAS 24.17A (a) and (b) per ED amend IAS 24 (December 2008) now also considers joint control (in addition to control and significant influence as proposed in 2007). In this context, we propose that the IASB fully considers any consequential changes stemming from ED 9 *Joint Arrangements* and the respective standard expected to be issued in Q2 / 2009.

Question 2 - Definition of a related party

The exposure draft published in 2007 proposed a revised definition of a related party. The Board proposes to amend that definition further to ensure that two entities are treated as related to each other whenever a person or a third entity has joint control over one entity and that person (or a close member of that person's family) or the third entity has joint control or significant influence over the other entity or has significant voting power in it.

Do you agree with this proposal?

Why or why not?

If not, what would you propose instead and why?

Subject to our concerns as explained in the first section of our answer to Question 3 - we generally agree with the proposal of the definition of a related party, but would like to add the following comments:

1) In (b) (vii) and (x) of the definition of a related party as proposed in the ED, a related party relationship will be established in the event that there is significant voting power in an entity. However, if there will be significant influence over that entity, a related party relationship will not be established. In this context we wonder what is the rationale to define a related party on the basis of a relationship presumably providing less influence (ie significant voting power), but not on the basis of a relationship providing a higher level of influence (ie significant influence)?

   We further propose defining the term 'significant voting power'. Although the term is used in the current text of IAS 24 and in other standards (eg IFRS 3.B15(b) (2008) where the similar term 'significant voting interest' is used), it is nevertheless not a defined term in IFRS. This bears the risk of inconsistent and divergent application in practice. We also propose that the definition should be specifically set in relation to the term 'significant influence'.

2) We understand that a precise and practicable definition resolving the issue in full might not be achievable. Accordingly, we propose to incorporate a rebuttable presumption when significant voting power needs to be assumed. We believe that this would be a significant help in all unclear situations.

Question 3 - Definition of a related party

Do you have any other comments on the proposals.

First of all, we are concerned that the IASB did not follow the arguments brought forward in our comment letter of May 2007 with respect to the definition of the term 'related party'. We, again, suggest reconsidering the current as well as the proposed definition of a related party relationship. The reason is, that both versions assume that the existence of significant influence is sufficient to influence transactions between the reporting entity and the related party in such a way that the transactions would not have been entered into or would not have been entered at conditions different from market rates. We believe that normally this is not true. Significant influence is defined as the power <u>to participate</u> in the financial and operating policy decisions of an entity but not as to control these policies. We are of the opinion that this kind of power, ie participation only, is normally not sufficient to influence transactions of that entity in the aforementioned sense.

In addition, in practice reporting entities quite often encounter serious difficulties to obtain the relevant information from associated companies therewith confirming that significant influence does not provide the relevant power as assumed by the IASB.

As a result the definition should be limited to those relationships which are of (joint) control character. This would not only enhance the practicability resulting in a considerable relief for preparers, but would also improve the explanatory power of the reported disclosures by eliminating potentially misleading disclosures. Hence, users would benefit from this limitation, too.

Further comments relate to the definition of a 'related party' as follows:

- The definition of a 'related party' is worded in para. 9 (a) of the ED as follows: 'A person or a close member of that person's family is …'. We consider this wording not to be clear since in our understanding the following is meant: 'If a person
  (i) is a member …,
  (ii) has control …; or
  (iii) has joint control, …,
  the person and all close members of that person's family are related to the reporting entity.' If our understanding is correct, we suggest that the IASB clarifies the wording.

- According to para 9 (a) (i) of the ED, a person or a close member of that person's family is related to a reporting entity if that person is a member of the key management personnel of <u>a</u> parent of the reporting entity. The respective wording in IAS 24.9 (d) makes reference to <u>the</u> parent of the reporting entity ('… its parent;'). If the IASB still intends to define the key management personnel or a close member of that person's family of <u>the immediate</u> parent of the reporting entity to be a related party, we recommend clarifying the wording accordingly.

- The term 'related party' as defined in IAS 24.9 (f) explicitly states that the relationship between the two parties mentioned in that paragraph may be established either 'directly or indirectly'. However, the definition in para. 9 (a) of the ED does not include such a clarifying comment. We suggest also using the term 'directly or indirectly' in the new definition for clarity purposes.

- The definition of a 'related party' in para. 9 (b) (iii) of the ED states 'both entities are joint ventures of a third party.' In this context we propose:
  - to investigate whether the term 'party' may need to be replaced by the term 'entity', which we believe to be appropriate;
  - to investigate whether the term 'entity' may be used inconsistently across IFRS (eg in IAS 24 the term would exclude persons (individuals), whereas in IAS 32, in the definition of a financial instrument, it would be a generic term for both entities and persons (individuals)).

- In para. 9 (b) (ix) of the ED two requirements are listed which must be met to establish a related party. In this context, (A) and (B) are used as list elements, which is confusing since (A) and (B) inappropriately may be understood to be two different parties. We suggest clarifying the wording.

With respect to the amendments previously proposed in the first exposure draft (*State-controlled Entities and the Definition of a Related Party* – issued in February 2007), from which we understand that the Board has completed its discussion, we would – nevertheless - like to raise the following issues:

- If the IASB does not follow our concerns regarding significant influence as outlined in our response to Question 3, we suggest amending the proposed term 'state-controlled entities' to 'state-influenced entities' as this would better reflect all three situations according to which a state has control, joint control or significant influence over a reporting entity.

- Para. 3 of IAS 24 (scope) will also use the term 'individual financial statements' in addition to 'consolidated and separate financial statements', which we suggest to further define or explain in the BC of IAS 24 since this term is neither included in the Glossary of Terms nor defined in a standard. We further suggest considering whether reference should be made to the term 'combined financial statements' – and if so, the term should be defined / explained in IAS 24.

- The proposed amendment to the definition of close family members by deleting the term 'may' (ED amend IAS 24 – February 2007) is in our view too far-reaching. We are of the opinion that the same fundamental idea, as mentioned above (first paragraph to question 3), should be considered when deciding whether all close family members should be regarded as related parties. A limitation to a smaller group of dependants, determined on the basis of a clear underlying principle, would be helpful for preparers and users.

- We suggest redrafting the definition of 'State' as follows: 'A *state* is a <u>supra-national,</u> national, regional or local government<u> or government agency</u>'.

  We propose this redrafting since we consider it necessary to include supra-national governments (eg the European Union) in the definition. Further, in the context of the current discussion we consider state departments and agencies as part of the state (they are not 'entities' controlled by the state) and therefore a related clarification should be given. We also wonder if there is a major application problem caused by the definition of the term state, because in many cases one entity is controlled by Federal Ministry A and another is controlled by Federal Ministry B. In such instances it remains unclear whether this relationship is covered by the proposed exemption. We recommend that the IASB shall clarify this situation in the wording of the definition of para. 11A to be added to IAS 24.

- We fully agree with the proposed wording of IAS 24.17, according to which commitments must be disclosed if an entity has entered into such related party transactions. However, we consider the corresponding wording in IAS 24.20 (j) not to be clear at all. We suggest that the IASB revises IAS 24.20 (j) by making clear whether commitments and/or executive contracts and/or future transactions subject to a condition are meant and by ensuring a corresponding wording with IAS 24.17.

- With regard to IAS 24.20, we also suggest clarifying whether or not dividend payments are part of related party transactions as this is a frequent question in practice. We are of the opinion that dividend payments do not meet the requirement of being a transfer of resources, services or obligations between the reporting entity and the related party.

- We also recommend that the IASB stipulate that the proposed amendments to IAS 24 apply prospectively, with the exception that first-time adopters shall apply any proposed reliefs in related party disclosures retrospectively.