
Submission to the Commerce Commission

on

Input methodologies review: Related
party transactions – draft decision

*PwC submission in our
capacity as auditors of
electricity distributors*

27 September 2017

Introduction

Overview

1. This paper forms our submission on the Commerce Commission's (Commission) draft decision and determinations guidance for related party transactions, released on 30 August 2017 (the draft decision). This submission has been prepared by PricewaterhouseCoopers (PwC) in our capacity as auditors or appointed auditors on behalf of the Auditor-General of 8 Electricity Distribution Businesses (EDBs).
2. Most of the EDBs we are the auditors for regularly enter into related party transactions for opex or capex transactions and are therefore directly impacted by the draft decision.
3. We trust this submission provides useful input to your consultation on the draft decision. We would be happy to answer any questions you may have regarding this submission.
4. The primary contacts for this submission are:

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Our response

We support a principle based approach and incorporation of accounting and assurance standard related party references

5. We welcome the Commission's decision to incorporate well-known and understood related party terms as defined in accounting and assurance standards by reference into the IM and ID determinations.

The related party definitions are however not yet aligned to accounting standards

6. The definition of a "related party" as per the IM is an adjusted definition from NZ IAS 24 *Related party disclosures* and therefore does not align to the incorporated accounting standard. NZ IAS 24 defines a related party as;
 - (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 of 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/of a parent of the reporting entity.
 - (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) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity."
7. Part (a) of the IM related party definition refers to "a person that is related to the EDB...as specified in the definition of 'related party' in NZ IAS 24".
8. The definition as per the IM therefore only seems to capture individuals such as shareholders/members, directors, key management personnel and their close family. The inclusion of transactions with related persons are unlikely to be those intended to be captured in the IM definition as they typically include distributions/dividends, directors fees and key management remuneration. The vast majority of related party transactions and certainly those that might most affect prices would be with related entities. We therefore believe that is more consistent with the policy intent to refer to "an entity that is related to the EDB.... as per NZ IAS 24" as above.
9. The inclusion of part (b) of the IM related party definition extends the scope of what is a related party beyond that as per the accounting standard. This raises the risk that the rules may be misinterpreted or misapplied. We question whether part (b) of the definition is necessary to meet the policy intent. As required under the IM we would expect costs to be appropriately allocated between divisions of an EDB under the cost allocation methodology.
10. The definition of a "related party transaction" as per the IM is also not consistent with that as per NZ IAS 24 *Related party disclosures*. It is unclear in the draft decision why this definition is not aligned to the accounting standard. We submit that to avoid confusion all terms should align to accounting standards where practical.

The additional assurance and disclosure requirements will increase compliance costs

11. The level of prescription in the disclosure requirements will add additional compliance costs and may limit auditors' ability to conclude on certain matters. The additional disclosures required as per clause 2.3.6 – 2.3.11 of the ID determination are included in the "Audited disclosure information" definition and auditors will therefore have to form a view on each of these disclosures.
12. We have commented on each of the broad areas of additional disclosure in more detail below. We have also appended a marked-up version of the proposed draft determinations which address the point raised below, and elsewhere in this submission.

Related party relationships

13. Clause 2.3.9 of the ID determination lists certain disclosures required including some of which refers to the nature of the relationship. Not all potential related party relationships are listed and clause 2.3.9 (1)(b) is not in line with NZ IAS 24, eg. common board members or senior management does not necessarily result in a related party relationship. Less prescriptive disclosures focused on the nature and extent of related party relationships and transactions will provide better information to readers.

Procurement policies and processes and practical examples of their application

14. In addition to disclosing a summary of the related party procurement policy publically, and the full policy to the Commission, EDBs will be required to describe how they apply their policies in practice by including a number of specific disclosures. Auditing these specific disclosures will be costly and problematic if there is insufficient appropriate evidence available to support specific attributes of the disclosures made. As an example, it may be difficult to opine on whether an EDB's specific reasons for using a related party are the true reasons, due to a lack of explicit supporting evidence.
15. The reasons why related parties are used, will usually be evident from the disclosed procurement process/policy and the required examples which will be included in the audited information. We submit that a broader requirement is more appropriate which will allow auditors to consider whether the disclosures made are sufficient to allow readers to understand how the policies are applied in practice.
16. Disclosure of procedures of the EDB concerning the referral of a consumer to a related party in connection with goods or services related to the electricity distribution service is required under clause 2.3.9(3). These transactions are typically not captured as related party transactions and therefore will not be disclosed as such in the ID schedules. The purpose of inclusion of this disclosure is unclear as it does not affect the costs to consumers regulated under Part 4 of the Commerce Act.

How the Directors will decide whether the policy is largely applied in practice

17. Disclosure of how the Directors have decided the policy is largely applied in practice is covered by Directors' certification. Additional assurance and disclosure is therefore unnecessary.

Examples of when the EDB last tested the arm's-length terms in the market

18. We support the notion of not including prescriptive requirements on how the EDB chooses to test the market. The discretion provided gives EDBs the ability to provide a range of evidence to auditors to satisfy the arm's-length basis of transactions. The potential range of evidence is expected to vary in nature and quality and accordingly the assessment of it is likely to require significant auditor judgment.

19. The guidance document provides some examples that the EDB may consider such as benchmarking, open tender process, market testing and independent market valuation and other processes. We accept that these examples can provide evidence however depending on the quality and nature of support provided by the EDB there will be instances, especially in a non-market environment, where we will be unable to opine as there may not be sufficient independent evidence available to support the arm's length assumption.
20. We also draw your attention to paragraph A42 of ISA (NZ) 550 which highlights practical difficulties that auditors face when required to opine on whether the related party transaction terms were on an arm's-length basis. This is a real concern as the usual approach adopted by auditors is to remove the phrase "on an arm's length basis" as the work required to be done to give this opinion could be extensive and could still result in there being insufficient appropriate evidence to support the statement.
21. The auditor may possibly be able to confirm that a related party transaction has been conducted at market price however it may be impracticable to confirm whether individual terms and conditions of transactions (including credit terms, contingencies, warranties and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. We recommended amendments to the ID determination to reflect an element of materiality on the terms and conditions to allow us to conclude appropriately where practicable.

Additional AMP disclosures including a map of future expenditure

22. The AMP disclosure requirements in clause 2.3.10 – 2.3.11 of the ID determination should not form part of the required audited disclosed information. Other AMP information does not form part of audited information and including only these requirements will increase compliance costs. The AMP information is also due at a different time than the Information Disclosures Schedules and Independent Auditors' report thereon. A different opinion will be required for these disclosures specifically. We don't believe the intent was for these additional disclosures to be audited and therefore recommend audited disclosure information are limited to those required by clauses 2.3.6 to 2.3.9.

Changes to the wording in the auditors' report are required

23. The assurance requirements as per clause 2.8 of the ID determination have been expanded to include specific assurance around the related party transactions within the Independent Auditors' report.

Reference to ISA (NZ) 550 and NZ IAS 24 in our opinion

24. As per clause 2.8(2) of the ID determination the assurance report must now include "a review of related party transactions in accordance with ISA (NZ) 550 and NZ IAS 24."
25. ISA (NZ) 550 specifically deals with the auditors' responsibilities related to related party relationships and transactions in an audit of financial statements. As the standard sets out specific audit procedures and risks assessments required for the audit of financial statements these will not necessarily be applicable to other engagements and therefore does not form part of SAE3100 and ISAE (NZ) 3000 standards. We agree with the reference to ISA (NZ) 550 in defining an arm's-length transaction to assist consistent application however do not believe it is appropriate to include a reference to the financial statement assurance standard in our assurance report on the Information Disclosure.
26. Even though we support the reference to NZ IAS 24 in defining related parties, we do not believe the inclusion of NZ IAS 24 in the assurance reports is appropriate. This is an accounting standard not an assurance standard and therefore auditors cannot conduct assurance engagements in accordance with it. NZ IAS 24 is also only used as a reference for limited definitions in the IM and therefore stating full compliance is not appropriate.

Specific opinion on the related party transactions

27. The draft decision and determination guidance document expresses a clear desire for assurance as to whether related party transaction values and disclosure in the disclosure year meet the general related party transactions valuation rule. The opinion as per the ID determination however refers to the valuation being in compliance with the ID and IM determination, which in turn includes the general related party transaction valuation rules.
28. The required disclosures and other general requirements will be covered as part of the overall compliance opinion as per clause 2.8.1 (1). We believe the determination of whether related party transactions were conducted on an arm's length basis or otherwise is an opinion and not a compliance statement. Given the significance of the arm's length principle we recommend this is dealt with as a separate conclusion rather than part of the compliance within the Auditors' report. We recommend a separate conclusion as below is included:

“whether (and, if not, the respects in which it has not), in the independent auditor's opinion, the EDB has valued, in all material respects, related party transactions at no more than the value as if it were on an arm's-length basis, as per clause 2.3.6 of this determination and clauses 2.2.11(1)(g) and 2.2.11(5) of the IM determination.”

29. Including separate conclusions on the representative examples being in accordance with the EDBs general practice and in accordance with the methodology applied is unnecessary. The ID determination requires the disclosure of representative examples and the methodology applied in practice on testing to market transactions. As part of an auditors normal procedures to confirm compliance the appropriateness of these disclosures will be tested.
30. Should the Commission retain the separate conclusions the current wording suggested on related party transactions do not conform to assurance standards. These will need to be updated to reflect an element of materiality and more appropriate terms such as “materially consistent with”.

The form of the assurance report

31. The proposal to provide guidance on the form of the assurance report, based on the auditing standards for forming an opinion on financial statements because they provide more detailed guidance than the assurance standards on which the independent assurance report is based is not appropriate.
32. The draft decision suggests that in addition to those matters required in the auditors' report as per SAE3100 and ISAE (NZ) 3000 all relevant matters that would be applicable as set out in a number of other ISA (NZ) standards should also be reported, as below:
 - International Standard on Auditing (New Zealand) 700, *Forming an Opinion and Reporting on Financial Statements*
 - International Standard on Auditing (New Zealand) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
 - International Standard on Auditing (New Zealand) 705, *Modifications to the Opinion in the Independent Auditor's Report*
 - International Standard on Auditing (New Zealand) 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
33. These auditing standards are applicable to audits of historic financial information only and are not applicable to SAE 3100 and ISAE (NZ) 3000 reports. In addition the matters covered by the above ISA (NZ) standards in relation to the auditors' report are covered in detail within SAE 3100 and ISAE (NZ) 3000.

34. The guidance document is unclear as to what the concern is around the application of SAE3100 and ISAE (NZ) 3000. It seems that there may be a desire for auditors to provide more detailed information on the basis of forming their opinion and communication of certain key matters such as per recent developments in audit opinions in relation to financial statements of listed entities under ISA (NZ) 701.
35. As previously highlighted this standard is only applicable to audits of historical financial statements of a limited group of entities (mostly those listed on the NZX). Within SAE 3100 (paragraph A55) the auditor may expand the content of the assurance report to include other information and explanations that do not directly affect the opinion, but provide additional information the users. Whether to include such additional information is a matter of auditor judgement and depends on the significance to the needs of the intended users.
36. Should the Commission require additional information from the auditor that may not directly affect the opinion, then guidance on what type of information and when this may be required should be issued. We note that the costs associated with providing additional information in assurance reports is significant and users may get little additional benefit from its inclusion.

The level of assurance required and purpose of the independent appraiser report is unclear

The lack of standards to be applied to the independent appraisers report brings into question the purpose and reliance that can be placed on them

37. The requirement for an independent appraiser in the case of a qualified audit report or where related party transactions exceed 65% of capex or opex will increase compliance costs through additional disclosures and assurance required. It is therefore important that the purpose and basis of the independent appraiser report are clear to ensure the appropriate reliance can be placed on them.
38. We are concerned over the nature of the independent appraiser's engagement and the expected standards to be applied. The ID determination has not prescribed the standards to be applied however it appears the Commission is seeking assurance over the additional information. Auditors will be required to apply the appropriate assurance standards when preparing an independent appraiser report, others might not.
39. The opinion required from the additional independent report is similar to that required from the auditors' report with both providing an opinion on compliance with clause 2.3.6 of the ID determination and clauses 2.2.11(1)(g) and 2.2.11(5) of the IM determination. Unless the expectation is that this will be to a lower level of assurance, the disclosure of additional information should not result in a different conclusion to that formed in the auditors' report.
40. The draft decision indicates a desire to simplify the requirements by aligning definitions to those used in accounting and assurance standards to ensure consistent interpretation. We note that even though terms such as "related party" and "arm's-length transactions" are well known and understood by the accounting and auditing professions this might not be the case for other professions.
41. We consider that there is a risk that if the same standards are not applied by independent auditors and independent appraisers (where they are different) to form an opinion on the same matter that different conclusions might be reached. This will cause confusion and brings into question the purpose of the appraiser report given a conclusion on compliance has already been formed by the auditor. The level of reliance that can be placed on the independent appraiser's report is therefore uncertain.

42. We recommend the Commission consider whether the independent appraiser report is the most effective method in obtaining additional information. There may be other mechanisms through which it can obtain additional information where it is deemed necessary. The assurance obtained on these, where required, can be on a similar basis as other information disclosed.

Should the Commission retain the Independent Appraiser report requirement the following changes should be considered

43. We note an inconsistency between the guidance document and the ID determination as to when an independent appraiser report is required. Clause 2.8.3 (4) is inconsistent with the guidance document 4.38.4. We expect the ID determination should be updated to ensure where a modified assurance report is issued in the prior period and time constraints did not permit the preparation of an additional independent report for that preceding year, the appraiser's report is required in the following year.
44. An EDB may elect not to obtain an additional independent report under certain circumstances. We question whether the 5% increase in the transaction values is the most appropriate threshold to use. The auditors' opinion on the disclosure of consistently applied policies should provide comfort that the policies and information disclosed previously remains appropriate, this will only be for clauses 2.8.3(1) and 2.8.3(2) however.
45. If an EDB continues to obtain a qualified auditors report, is it not appropriate to require an additional appraiser report every time a qualified opinion is issued? This clause will otherwise put more pressure on entities with >65% of related party transactions rather than those who continue to receive qualified opinions, which does not appear to be the intention.

We have included marked-up versions of the draft determinations

46. We have appended a marked-up version of the proposed draft determinations for the Commission's consideration. These amendments:
- Update the definition of a related party;
 - Reduce the level of prescription in terms of the form of related party disclosure, and remove some unnecessary layers of disclosure such reasons for using related parties;
 - Update the assurance report requirements to align to assurance standards; and
 - Remove the requirement for an independent appraiser.