PUBLIC SECTOR
ACCOUNTING BOARD

PSAB
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CONSEIL SUR
LA COMPTABILITÉ
DANS LE SECTEUR
PUBLIC

Related Party Disclosures

Basis for Conclusions

Section PS 2200

CPA Canada Public Sector Accounting Handbook

Prepared by the staff of the Public Sector Accounting Board

Foreword

CPA Canada Public Sector Accounting Handbook Revisions Release No. 42, issued in March 2015, contained a new standard, RELATED PARTY DISCLOSURES, Section PS 2200.

The primary objective of a Basis for Conclusions document is to set out how the Public Sector Accounting Board (PSAB) reached its conclusions. As well, it sets out significant matters arising from comments received in response to the proposals exposed and indicates how PSAB has dealt with the issues raised.

These documents are intended to assist financial statement users, preparers, auditors and other parties interested in public sector financial reporting in understanding the rationale followed by PSAB when developing standards.

This document has been prepared by staff of PSAB. It does not form part of the CPA Canada Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles (GAAP). Basis for Conclusions documents also do not include any guidance on the application of the relevant Section or Guideline.

March 2015

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BACKGROUND

1 PSAB initiated a project because the CPA Canada Public Sector Accounting (PSA) Handbook did not have an overarching standard on related party transactions. Filling this gap was particularly important since many public sector entities were adopting public sector accounting standards that had previously followed the CPA Canada Handbook – Accounting. For example, government not-for-profit organizations that adopt the PSA Handbook without Sections PS 4200 to PS 4270 (the PS 4200 series) would find no guidance comparable to that which they had previously followed.

2 In the absence of a standard, a public sector entity would be required to develop accounting policies in accordance with GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150. PSAB concluded that there may be negative implications for public sector entities in adopting other authoritative standards. Other authoritative standard setters have developed very broad definitions of a related party that could expand the relationships that would be disclosed. The objectives of other authoritative standard setters that drive the requirements in their standards may not be consistent with the objectives of public sector financial statements. For example, others may place a high emphasis on disclosure of transactions with key management personnel and their close family members including, in some cases, compensation arrangements. Other authoritative standard setters may have different thresholds when assessing reportable related party transactions. Given the nature of the relationship, a transaction may be material regardless of its size. Other authoritative standard setters may require the measurement of related party transactions.

3 The purpose of the project was to develop a standard that would apply to public sector entities that, for purposes of their financial reporting, adhere to the standards for governments in the PSA Handbook. It would:

(a) define a related party;

(b) establish criteria for identifying related parties from the perspective of the entity that is reporting;

(c) identify the circumstances in which disclosure of transactions between the entity that is reporting and its related parties is required; and

(d) set out disclosure requirements.

4 As part of the project, PSAB considered the need and advisability of establishing recognition and measurement standards for related party transactions of governments and government organizations. Issues of recognition and measurement generally arise when related party transactions occur between entities that are part of the same reporting entity. A variety of

reporting practices regarding the recognition and measurement of related party transactions exist among public sector entities. Some consistency in practices would make financial statements more comparable and understandable for users.

5 In October 2011, PSAB issued an Invitation to Comment to seek feedback on a proposed standard for the disclosure of information about transactions between an entity preparing financial statements and its related parties. Concurrently, an Issues Paper was issued seeking views on the need for the inclusion of standards that should be applied in recognition and measurement of related party transactions.

6 Respondents, although raising issues with specific proposals, were generally supportive of the definitions and disclosures proposed in the Invitation to Comment. As well, respondents generally supported inclusion of guidance on recognition and measurement. In September 2012, PSAB issued an Exposure Draft of a proposed new Section on related party transactions. The Exposure Draft took into account comments received on the Invitation to Comment and Issues Paper.

7 After deliberating the issues raised by respondents to the September 2012 Exposure Draft, PSAB concluded that the changes to the proposed standard were significant and required re-exposure. PSAB issued a Re-exposure Draft in June 2013.

8 After deliberating the issues raised by respondents to the June 2013 Re-exposure Draft, PSAB again concluded that the changes to the proposed standard were significant and required re-exposure. PSAB issued a Re-exposure Draft in April 2014.

Separating the standards

9 After considering the responses to its 2011 Issues Paper, PSAB concluded that a Section on related party transactions should include recognition and measurement guidance. The proposed guidance in the June 2013 Re-exposure Draft focused on recognition and measurement of transactions occurring between entities that are part of the same government reporting entity by referring to provider and recipient organizations.

10 This created a subtle issue within the standard. For example, related party transactions can include transactions between the reporting entity and individuals who are members of key management personnel and close members of their family. They could also include transactions with entities that are controlled by members of key management personnel or that have key management personnel in common. A related party may be a government partnership with one or more private sector partners. The government

partnership may apply the standards in the CPA Canada Handbook – Accounting to account for related party transactions.

11 Generally, issues of recognition and measurement would not arise for those related party transactions between individuals and entities that are not part of the same government reporting entity. They would be recognized at the exchange amount according to their substance and individual accounting standards applied for reporting purposes. Disclosures about these related party transactions would be sufficient for users to understand the effect of those transactions on an entity's financial position and changes in financial position. This may conflict with the proposed general principle that related party transactions, with certain exceptions, would be recognized at their carrying amount.

12 In the April 2014 Re-exposure Draft PSAB proposed to issue two new Sections on related party transactions. The first Section defines a related party and establishes disclosures required for related party transactions. The second Section deals specifically with how to account for and report transactions between entities controlled by a government and that comprise its reporting entity from both a provider and recipient perspective.

13 The majority of respondents to the April 2014 Re-exposure Draft agreed with the proposal to create two new Sections. Two respondents, while not disagreeing with separation, commented that it would be more useful, and the clarity and consistency of application of the standard would be improved, if all definitions as well as recognition and measurement and disclosure requirements were located in the same standard. Two other respondents disagreed because they had issues with the proposed scope of the recognition and measurement standard. The latter respondents argued that the standard should be applicable to all related party transactions, not just transactions between government components and organizations under the control of a government that are part of the same government reporting entity.

14 After deliberating the issues raised by respondents, PSAB remained of the view that, in general, other related party transactions would be recognized in accordance with the standards the related parties apply in the preparation of their financial statements. Additionally, the requirements in a Section on recognition and measurement of related party transactions may conflict with these other standards.

15 RELATED PARTY DISCLOSURES, Section PS 2200, incorporates the proposed guidance for related party disclosures in the April 2014 Re-exposure Draft with one change as a result of redeliberating the issues raised by respondents. The final standard also considers the major issues raised by respondents to the

previously issued Invitation to Comment, Issues Paper, Exposure Draft and June 2013 Re-exposure Draft.

APRIL 2014 RE-EXPOSURE DRAFT

16 Several respondents were concerned that the April 2014 Re-exposure Draft implied that if a member of key management personnel of the entity that is reporting was also a member of key management personnel of another entity, it is more likely to create a related party relationship. It was argued that the guidance should state clearly that whether the entities are related depends on the level of influence the member of key management personnel has over the decision-making process of both entities.

17 To clarify the intent, Section PS 2200 states that in determining whether the participation of a member of key management personnel would be sufficient to affect the policies of both entities in their mutual dealings, it is necessary to consider both the level of influence the member of key management personnel has over the decision-making process of both entities and the likelihood the individual is able to affect the policies of both entities in their mutual dealings.

IMPLICATIONS OF IMPLEMENTATION

18 A number of respondents expressed concern about the implications of implementation of the proposed Section. They questioned the practicality for a government to identify all related parties and transactions for disclosure given:

(a) the breadth and nature of government operations and activities;

(b) the pervasiveness of related party relationships and transactions that are common in the public sector environment; and

(c) the fact that the majority of transactions public sector entities engage in to achieve policy objectives, unlike private sector entities, are non-market transactions.

19 It has also been argued that disclosures of transactions with individuals who are members of key management personnel of an entity preparing financial statements and their close family members would be an onerous task. The costs would outweigh any perceived benefit of accountability from such disclosures. In addition, obtaining this information is not practical for general purpose financial statements of senior governments. Given the definitions, the list of possible individuals who would be included is very extensive. The controls and procedures to produce a listing of these related parties and identify related party transactions to satisfy auditing requirements are impractical.

20 To address concerns about the implications of implementation, Section PS 2200 clarifies that disclosure is only required when the transaction amount is different from that which would have been arrived at with unrelated parties.

Additionally, although standards generally are not intended to apply to immaterial or insignificant items or matters, Section PS 2200 clarifies that disclosure is only required when these transactions have had, or, if not recognized, could have had, a material financial effect on the financial statements.

21 When determining whether related party transactions are reportable, consideration is given to the objective of Section PS 2200. The disclosure of information about the terms and conditions on which transactions between related parties were conducted and the relationship underlying them is sufficient to enable users to assess the effect that they may have had on the reporting entity's financial position and financial performance. When assessing whether related party transactions are reportable, the quantitative characteristics of materiality are considered. Certain related party transactions are of such financial significance that it is essential that they be adequately described in the financial statements in order to provide users with an understanding of the entity's financial results and position.

22 Judgment is applied in determining which transactions are reported and the level of detail required for fair presentation. Section PS 2200 includes a number of additional factors for consideration when exercising judgment in assessing reportable transactions. These factors include, but are not limited to:

(a) the nature of terms and conditions attached to the transactions;

(b) the financial significance of the transactions;

(c) the relevance of the information to users; and

(d) the users' need for the information to understand the financial statements and make comparisons.

23 The effect of Section PS 2200 on a government reporting entity is expected to be minimal. It does not deal with transactions with entities within a reporting entity that are eliminated on consolidation or with entities accounted for on the modified equity basis.

24 Related party transactions with members of key management personnel and their close family members would generally not be financially significant at the government reporting entity level. As well, most jurisdictions have established financial disclosure and conflict of interest legislation. Entities that are subject to such legislation are likely to have processes in place to protect the integrity of financial transactions and provide accountability to the public. These processes may be leveraged to comply with Section PS 2200.

25 Those government organizations that were previously using pre-changeover accounting standards in Part V of the CPA Handbook – Accounting may have to

adjust their current disclosures because Section PS 2200 does not include significant influence. Significant influence is generally defined by standard setters as the power to participate in the financial and operating policy decisions of an entity, but not control those policies. In addition to significant influence being gained by ownership interest, statute, or agreement, it may also be exercised in several ways, usually by representation on the board of directors or equivalent governing body or by participation in the policy making process or interchange of managerial personnel.

26 PSAB has determined that a related party does not include entities that have significant influence over, or are subject to the significant influence of, another entity because public sector entities (in particular, governments), have wide-ranging powers that would typically allow them to exert significant influence over the operating and financial policies of a broad range of parties in all sectors of the economy. As well, the term "significant influence", as used by other standard setters, is generally an accounting term that determines whether a reporting entity accounts for an ownership interest in another entity on the equity accounting basis. Moreover, the notion of significant influence over entities does not give rise to equity accounting in the standards in the PSA Handbook for associate entities and PSAB does not believe it necessary to introduce significant influence when defining a related party.

27 Government not-for profit organizations that have adopted the standards for not-for-profit organizations in the PSA Handbook have been applying DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS, Section PS 4260. If these organizations adopt the PSA Handbook without the PS 4200 series, they may have to make additional adjustments to their current disclosures.

MATERIAL FINANCIAL EFFECT

28 Although there is a general presumption that PSA Handbook standards are not intended to apply to immaterial or insignificant items or matters, the scope of Section PS 2200 reiterates that it is focused on disclosure of information about financially significant related party transactions that effect, or if not recognized, could effect, the reported financial position and changes in it. The term "material financial effect" is used to describe those related party transactions that may be reportable.

29 The focus on disclosing information about related party transactions that have had a material financial effect on financial statements is intended to avoid the reporting of "moral hazards" in connection with related party transactions in financial statements. Most Canadian jurisdictions have financial disclosure and conflict of interest and integrity legislation that require disclosure of information about these transactions in other public documents.

30 Some respondents were concerned that disclosures would be limited to just those transactions that had a material financial effect on the financial statements. They argued that when considering disclosure of related party transactions, the qualitative as well as the quantitative characteristics of materiality are considered. Information about related party transactions is often of more significance to a financial statement user than information about unrelated party transactions, regardless of the size of such transactions.

31 One respondent suggested that the scope limitation in paragraph PS 2200.04 should be rephrased to emphasize that the materiality of a related party transaction should be considered from the perspective of the significance of the transaction to the users and the effect on their decision making. Another respondent commented that the application of “material” in the context of the financial effect on financial statements may be problematic because paragraph A10 of Canadian Auditing Standard (CAS) 320, *Materiality in Planning and Performing an Audit*, in the CPA Handbook – Assurance, suggests that related party transactions may require a lesser materiality amount than materiality for the financial statements as a whole.

32 PSAB is of the view that the proposals in the Section are consistent with the objective of disclosure of information about the terms and conditions of related party transactions and the relationship underlying them (i.e., to enable users to assess the effect that the related party transaction have had, or, if not recognized, may have had, on an entity’s reported financial position and changes in it). This information is required to facilitate users’ assessment of accountability and for decision making.

33 PSAB is also of the view that there is no conflict between Section PS 2200 and CAS 320, *Materiality in Planning and Performing an Audit*. Under CAS 320, the key factor in determining materiality for one or more particular classes of transactions, account balances or disclosures is the influence they could reasonably be expected to have on economic decisions of users taken on the basis of financial statements. In particular, for public sector entities, it is based on the financial information needs of legislators and the public in relation to public sector programs.

34 There is no law or regulation affecting the expectations of users of the financial statements of public sector entities regarding the disclosure of related party transactions. Similarly, the PSA Handbook financial reporting framework would not affect users’ expectations regarding related party disclosures. The focus of the PSA Handbook is on meeting the financial information needs of users. Generally, materiality in the context of the PSA Handbook financial reporting framework is focused on financial effects of items.

TRANSACTIONS ACCOUNTED FOR UNDER THE MODIFIED EQUITY METHOD

35 Some respondents questioned the exclusion of transactions accounted for under the modified equity method. It is argued that since the modified equity method does not result in the elimination of related party transactions in consolidated financial statements, with specific exceptions provided for in INVESTMENT IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070, these transactions should be included in the scope of Section PS 2200.

36 INVESTMENT IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070, requires that consolidated financial statements should disclose transactions and balances with other organizations included in the reporting entity, contractual obligations and contingencies and the nature and terms of any guarantees. PSAB is of the view that the disclosures under Section PS 3070 give users an informative accounting of the full nature and extent of the financial affairs and resources of government business enterprises as well as the effect of their operations on the reporting entity. Separate disclosure is not required.

IDENTIFYING A RELATED PARTY

37 Most respondents agreed with the general definition of a related party. There was a consensus that related parties include entities that control or are controlled by an entity that is reporting, entities that are under common control and entities that have shared control over or that are subject to shared control of an entity that is reporting.

38 One respondent suggested that entities that are related because of shared control could be eliminated as GOVERNMENT PARTNERSHIPS, Section PS 3060, already requires disclosures of transactions and balances with those organizations included in the government reporting entity. The Section states that judgment would determine whether it is necessary to disclose information about related party transactions that is already reported on the face of the financial statements or in other notes to the financial statements.

Trusts under administration

39 Two respondents to the April 2014 Re-exposure Draft suggested that the definition of related parties should be expanded to include trusts. Some of these trusts, although controlled by the entity that is reporting, may not meet the definition of a related party because no benefits are derived from them. It was suggested that they should be considered related parties since transactions can occur between an entity in the government's reporting entity and a trust carrying out fiduciary transactions. The respondents did not indicate how control is exercised over trusts that carry out fiduciary activities.

40 PSAB is of the view that the guidance in paragraph PS 2200.08 would be applicable. Trusts with fiduciary responsibilities may be determined to be related parties if an individual(s) who is a member of key management personnel of the entity that is reporting is also a member of key management personnel of the trust and that individual is able to affect the policies of both entities in their mutual dealings. For example, if the majority of trustees are members of key management personnel of the entity that is reporting, it may be presumed, barring evidence to the contrary, that the individuals have influence over the decision-making process of both entities and that it is likely the individuals are able to affect the policies of both entities in their mutual dealings. If this is the case, the entities would be related parties.

Key management personnel

41 The issue of whether the definition of a related party includes individuals that are members of key management personnel of an entity preparing financial statements and their close family members has been the subject of much debate. It has been argued that governments generally have various legislation and processes in place to protect the integrity of financial transactions and provide accountability to the public (for example, conflict of interest legislation and guidelines, recuse provisions, publication of schedules of payments, procurement governance, etc.). Disclosure would be redundant since most Canadian jurisdictions have financial disclosure and conflict of interest and integrity legislation that require elected officials, nominees or designated employees to make financial disclosures and ensure the public has reasonable access to the information. As well, reporting on relationships and transactions with key management personnel is inconsistent with the purpose of financial statements intended to communicate financial information that provides an accounting of the administration of the financial affairs and resources.

42 The majority of respondents generally agree that the definition of a related party should include key management personnel of the reporting entity. There was no clear consensus on the issue of whether the definition includes close family members of key management personnel.

43 PSAB is of the view that a member of key management personnel should be included in the scope of the standard. By their nature, key management personnel are related parties. Because of their fiduciary responsibilities, extensive authority and power over the deployment of economic resources and responsibility for the strategic direction and operational management of an entity, users of financial statements require information about a reporting entity's transactions and outstanding balances with them. Information about the terms and conditions on which transactions with key management personnel were conducted is necessary as it may affect assessments of the reporting entity’s operations and risks.

44 As well, PSAB is of the view that the definition of a related party should include close family members of individuals who are members of key management personnel. These individuals may influence, or be influenced by, a member of key management personnel.

45 The issue of whether a related party includes entities that have a member of key management personnel in common has also generated a lot of debate. This issue is also related to comments made by several respondents that the Section should include the concept of “significant influence” in the characteristics of a related party. One respondent used the example of the relationship of post-secondary institutions and uncontrolled foundations.

46 In some instances, post-secondary institutions have not established control over foundations as defined in GOVERNMENT REPORTING ENTITY, Section PS 1300, and do not consolidate the foundations in their financial statements. However, the post-secondary institutions are able to influence the financial and operating policies of the foundations by participation in the policy making process. It was argued that if the standard does not include the concept of significant influence, those post-secondary institutions adopting the PSA Handbook without the PS 4200 series would not have to disclose information about potentially material transactions with foundations. This would make comparison between post-secondary institutions difficult.

47 Most respondents agreed that a related party includes an entity when a member of key management personnel of the entity that is reporting is also a member of the management or governing body of that entity. Others have argued a contrary view. Consistent with the conclusion of the International Accounting Standards Board, these relationships are not strong enough to create related party relationships.

48 PSAB has concluded that the ability of individuals who are members of key management personnel of an entity that is preparing financial statements to participate in the financial and operating decisions of another entity may affect the terms and conditions of transactions between the parties. This could affect the reported financial position and performance of the entity reporting. In determining whether the participation of a member of key management personnel would be sufficient to create a related party relationship, it is necessary to consider the level of influence the individual has over the decision-making process of both entities and the likelihood that the individual is able to affect the policies of both entities in their mutual dealings.

Typical related parties

49 The April 2014 Re-exposure Draft proposed a simpler approach for determining which entities and individuals are related to the entity that is reporting from that in the June 2013 Re-exposure Draft. The concept of “commonly controlled

entities" was used in the April 2014 Re-exposure Draft as the basis for identifying typical related parties.

50 The majority of respondents agreed that the approach proposed in the April 2014 Re-exposure Draft was useful and practical. One respondent questioned the need to identify typical related parties as it repeated the definitions contained in the proposed standard.

51 Two respondents felt that while useful, the proposed list of typical related parties was overly complex and difficult to follow. Two other respondents commented that there appeared to be some duplication in the typical related parties listed. As well, two respondents suggested that due to the technical and sometimes complex nature of related party relationships, illustrations or diagrams of the various related party relationships should be provided.

52 The final Section updates the definition of commonly controlled entities to reflect terminology changes in the Introduction to Public Sector Accounting Standards. It retains the list of typical related parties from the perspective of the entity that is reporting.

DISCLOSURES

53 Respondents were generally in agreement with the disclosure requirements. The disclosures will provide sufficient information about the terms and conditions on which transactions between related parties were conducted and the relationship underlying them to enable users to assess the effect that they have had, or, if not recognized, may have had, on the entity's financial position and financial performance.