



**August 10, 2012**

Memorandum

To: Members of the Board

From: Melissa Loughan, Assistant Director

*Wendy M. Payne*

Through: Wendy M. Payne, Executive Director

Subj: **Federal Reporting Entity—Related Party Tab C<sup>1</sup>**

**MEETING OBJECTIVES**

- To decide how to address disclosures regarding related parties.

Staff has recommended draft language and disclosure requirements that would be issued as part of the Exposure Draft (ED) *Identifying and Reporting upon Organizations to Include in General Purpose Financial Report*.

**BRIEFING MATERIAL**

The transmittal memorandum includes a discussion of issues and recommendations beginning on page 2 under Staff Analysis and Recommendations. A full list of Questions for the Board appears on the final page.

You may electronically access all of the briefing material at <http://www.fasab.gov/board-activities/meeting/briefing-materials/>

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

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## **BACKGROUND**

The Board considered related parties at the June meeting and provided input to staff. There appeared to be agreement that related parties should be addressed. However, the Board requested that staff come back with new options for consideration based on the feedback and input received at the meeting.

## **STAFF ANALYSIS AND RECOMMENDATIONS**

### ***Issue 1: Related Party Recommendation for ED***

Based on the June meeting and a review of the minutes, staff gathered there were differing perspectives among members in how related parties should be addressed. Staff was asked to explore options based on the feedback received from the Board. Staff believes the options could be narrowed to the following based on the Board's discussion:

- A narrow definition with a series of principles or examples of what to consider or exclude to help narrow the population.
- Misleading to exclude approach
- Sub-set of Non-core
- Part of Mr. Steinberg's revised framework

Several Board members believed related party needed to be addressed and guidance was necessary to assist in narrowing the population to ensure the definition isn't too broad. These members emphasized relying on examples to enhance the definition. Further, it was noted that other standard setters take this type of approach. Instead of defining related party explicitly, a series of principles and / or examples of what to consider or exclude helps narrow the population. In addition, reliance on the judgment of preparers and auditors regarding parties that would be misleading to exclude was suggested.

Another option discussed by at least two members involves integrating related party within the established draft framework of non-core, that is, making it a type of non-core entity.

Proponents for this approach may believe there is an advantage to this because:

- Some may view non-core as equivalent to related party (previously reported related parties are considered non-core)
- Some have difficulty defining another category and find it possible to be a subset of non-core

- There is flexibility with disclosures in non-core, therefore allowing for less disclosure when there is significant influence but not control
- Related party would not have to be defined since this could be a “related entity” category that falls just below the threshold for inclusion

Staff finds this approach difficult to develop and apply because there is a distinction between control (one of the inclusion principles) and significant influence. While the non-core category includes controlled entities designed to operate with relative influence (particularly to insulate them from political influence), these entities are subject to control rather than significant influence. Further, a distinction between those organizations and relationships that meet the inclusion principles and those that do not is needed to exclude entities influenced but not controlled. Those organizations that might meet related party reporting would not meet the inclusion principles. Therefore staff finds difficulty in meshing these organizations or making it a sub-set of non-core.

Staff also notes that it was suggested at the last meeting the category could be called something other than related party, such as “related entity.” Staff considered this option but believed there might be some confusion if new terminology replaces a widely accepted term. For example, the community may see it as a new category and might be still searching for “related parties” as well. Therefore, staff does not recommend changing the title.

## **Staff Recommendation**

As agreed in the June meeting, related parties should be addressed because of the potential for confusion given the long-standing approach to reporting related parties and the existing audit requirements. In addition, related party disclosures would provide for the wide variety of relationships as well as potential future relationships. Staff has provided a draft that relies heavily on listing parties to be included and excluded. In addition, the staff proposal provides room for judgment by incorporating a misleading to exclude provision.

Staff does not propose including related parties in the non-core category. The inclusion principles would need to be adjusted to permit entities that are not controlled to be included as non-core entities. Staff believes incorporating “significant influence” in the inclusion principles without the specific exclusions provided in the draft would lead to many more entities being included. Hence, the existing draft language regarding exclusions would still be needed. Staff believes a separate section addressing related parties would be clearer. Further, a related party definition is needed to resolve the initial staff concern that existing long-standing practices from the private sector would be imposed on federal agencies absent a federal definition.

## Staff Proposed Language:

### Related Party and Disclosures

(Applicable to both the Government-wide and CRE GPFFR)

1. In addition to entities for which Congress and the President are accountable<sup>2</sup>, the federal government may have the ability to exercise significant influence over other parties in making financial and operating decisions or to be influenced by its relationship with the other parties. Such relationships are numerous and not all warrant disclosure. Guidance is provided below but judgment will also be required to identify relationships that warrant disclosure as related parties.
2. **Related parties** are not controlled or owned by the federal government. Parties are considered to be related if the relationship or one party to the relationship has the ability to exercise significant influence over the other party in making financial and operating decisions.
3. Significant influence (for the purpose of this Statement) is the power to participate in the financial and operating policy decisions of an entity, but not control those policies. Significant influence may be exercised in several ways, sometimes by representation on the board of directors or equivalent governing body but also by, for example, participation in the policy making process, interchange of managerial personnel, or dependence on technical information. Significant influence may be gained by an ownership interest, statute, or agreement.
4. Significant influence does not arise from regulatory actions or economic dependency alone. However, regulation or economic dependency, together with other factors, may give rise to significant influence and therefore a related party relationship. Judgment is required in assessing the impact of regulation and economic dependence on a relationship.
5. Although significant influence exists among the component reporting entities of the federal government, component reporting entities are subject to the overall direction and operate together to achieve the policies of the federal government and are not considered related parties. Therefore, component reporting entities need not be disclosed as related parties by other component reporting entities.
6. In the context of this Statement, related parties *generally* would include:

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<sup>2</sup> Entities for which the Congress and President are accountable are in the budget, owned, or controlled and would meet the inclusion principles and be reported as either a core or non-core entity and not be subject to related party reporting.

- a. Government sponsored enterprises not meeting the Inclusion Principles
  - b. Organizations governed by representatives from each of the governments that created the organization wherein the U.S. government has agreed to ongoing or contingent financial support to accomplish shared objectives (for example, multi-lateral development banks)
  - c. Organizations of such significance – either financially or operationally – that it would be misleading to exclude the organization.
- 7. In the context of this Statement, the following *generally* would not be considered related parties:
  - a. Entities meeting the Inclusion Principles
  - b. Entities with which the federal government transacts a significant volume of business resulting in economic dependence such as government contractors, state and local governments, and non-profit organizations
  - c. Key executives
  - d. Entities owned or managed by key executives, other employees, or members of their families
  - e. Component entities of the federal government (see full discussion in par. 5)
  - f. Foreign governments
  - g. Organizations created through treaties or trade agreements that define common goals and means for joint action where the U.S. role in governing and financing the organizations is not significant
  - h. Special interest groups
- 8. Although par. 7 *generally* permits the exclusion of certain entities as related parties, other factors may create a need for related party reporting and disclosures. The use of judgment will be necessary in identifying those factors consistent with the information needs described in par 9.

9. Certain information regarding related party relationships may enable users to better understand the financial statements of the reporting entity because:
  - a. Related party relationships might expose the federal government to risks or provide opportunities that would not have existed in the absence of the relationship;
  - b. Related party relationships can influence the way in which the federal government operates with other entities in achieving its individual objectives; and
  - c. Related parties may enter into transactions that unrelated parties would not enter into, or may agree to transactions on different terms and conditions than those that would normally be available to unrelated parties.
10. For any Related Party, the following should be disclosed:
  - a. Nature of the federal government's relationship with the entity, including the name of the entity or if aggregated, a description of the related parties. Such information also would include as appropriate: the percentage of ownership interest.
  - b. Other information that would provide an understanding of the relationship and potential financial reporting impact, including financial-related exposures to potential gain and risk of loss to the reporting entity resulting from the relationship.

**Question 1: Does the Board generally agree with the proposed language for identifying related parties?**

**Question 2: Does the Board wish to offer any additional entities for exclusion?**

**Question 3: Does the Board approve the disclosure requirements?**

## **NEXT STEPS**

Staff will address any issues or concerns identified by the Board.

The goal of completing the ED shortly after the October 2012 meeting may require review of part or all of the ED between meetings. The October goal is contingent upon the Board's decisions and the extent of changes. Staff will propose a new timeline for completion at the October meeting.

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## **MEMBER FEEDBACK**

If you require additional information or wish to suggest another alternative not considered in the staff proposal, please contact staff as soon as possible. In most cases, staff would be able to respond to your request for information and prepare to discuss your suggestions with the Board, as needed, in advance of the meeting. If you have any questions or comments prior to the meeting, please contact me by telephone at 202-512-5976 or by e-mail at [loughanm@fasab.gov](mailto:loughanm@fasab.gov) with a cc to [paynew@fasab.gov](mailto:paynew@fasab.gov).

## **QUESTIONS FOR THE BOARD**

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**Question 2: Does the Board wish to offer any additional entities for exclusion?**

**Question 3: Does the Board approve the disclosure requirements?**