



June 14, 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 D¹**

MEETING OBJECTIVES

- To consider options for addressing related party.

The objective for the June Board meeting is to consider options for addressing related party. Staff has proposed a related party definition and disclosures 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. In addition, the following items are attached:

- Attachment 1: Related Party Issue Paper
- Attachment 2: Analysis of GSEs and MDBs
- Appendix 1: Text of GASB, IPSASB, and FASB *Related Party* standards
- Appendix 2: June 2011 Briefing Materials

¹ 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.

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

BACKGROUND

The Board considered related parties in June 2011 but deferred making a decision at that time. The Board determined it would make decisions regarding related party at a later date, once the other sections of the federal reporting entity standard were complete.

STAFF ANALYSIS AND RECOMMENDATIONS

The Attached Related Party Issue Paper provides the full staff analysis, but this Staff Analysis and Recommendation provides a brief overview of that paper and summary of key points, recommendations and questions.

Issue 1: Related Party Recommendation for ED

Given the universe of entities the federal government may have relationships with and where significant influence may exist, there could be countless relationships considered. One member concern has been if there are examples that warrant disclosure. Members have acknowledged that some of the current related parties may be considered non-core or core under the new proposed standards. Absent an example that should be disclosed, some question the need for the category.

Staff believes the most difficult step may be articulating the objective of related party reporting in the federal government because of the unique and diverse relationships as well as the extensive intra-governmental relationships. After considering the other standard setters' objectives, staff proposed the following which also became the basis for the related party definition:

Identify parties not controlled or owned by the federal government where an existing relationship may influence the federal government and/or implies the federal government has broadly assumed risk, or will in the future, that would not be expected to be assumed in arms length operating relationships. This assumption of risk is a result of the federal government's relationship with and ability to exercise significant influence over another organization.

Staff also strongly believes the Board should define 'related party' and address it within the federal reporting entity standard for several reasons:

- Related party reporting is such a fundamental notion within GAAP and the auditing standards that addressing how related party concepts apply in the federal domain is important. Absent a clear articulation of related party concepts

and concerns in the federal domain, we may find the private sector concepts applied by default.

- There is still a need for the related party category to disclose those organizations that aren't covered by the proposed standards where there may still be a relationship of influence. Such organizations do not meet the requirements for inclusion in the GPFFR (ie. Inclusion principles) but significant influences may exist.
- One can't anticipate all types of relationships the federal government may have or might have in the future that need to be reported.
- The standard needs to address things that may not fit the criteria for core and non-core, specifically those relationships where there may be a level of influence but not control or ownership. Therefore, there should be provisions for how to report those types of organizations that fall outside core and non-core.

To further demonstrate staff considered two potential relationships—government sponsored enterprises and multilateral development banks and provided an overview of the background, relationship/influence, and risks/exposures for the Board's consideration. Based on considering the two examples above, these appear to be potential candidates for related party disclosure or at a minimum staff believe enough to warrant the standards to provide for a related party disclosure.

Staff believes the most important disclosure would be to report the nature of the relationship and any potential risks and exposures. The disclosures would not be as extensive as for non-core entities.

Staff also believes the government-wide and component reporting entity should apply the same standards though the materiality is different and therefore not all related parties would be included at the consolidated government-wide level.

Staff presents draft Related Party language for incorporation into the ED. See pages 6-8 of Attachment 1-- Related Party Issue Paper for the Draft Language.

Question 1: Does the Board generally agree with the Staff Recommendation for Related Party?

Question 2: Does the Board generally agree with the proposed language for the ED?

Issue 2: Component Reporting Entity Issue

The Board previously discussed the issue of whether component reporting entities should disclose additional information to better recognize the relationship and contextual information that is conveyed about the component reporting entity of a sovereign government. One member raised the concern that readers may need additional contextual information to understand component reporting entity (CRE) information.

FASAB has not established requirements for a description of the CRE other than the discussion of the organization and mission required in the Management's Discussion and Analysis section (MD&A). Nonetheless, most key points are addressed individually in agency MD&A and notes either as a result of existing standards, OMB form and content requirements, or voluntarily. However, coverage and placement differs among the agencies we reviewed. Examples are included in the issue paper (attachment 1). Staff recommends establishing minimum requirements.

Question 3: Does the Board believe 'Note 1' should include certain minimum information regarding the CRE's status as a component of the U.S. government?

Question 4: If so, does the Board believe information regarding any² of the following should be required as part of an integrated discussion of the entity's status as a component of the U.S. government:

- a. Notice that the CRE is a component of the U. S. government, a sovereign entity**
- b. Discussion of going concern (need for continued authorizations and appropriations)**
- c. Discussion of costs not included in CRE statements**
- d. Caution regarding ability to liquidate liabilities not covered by budgetary resources**
- e. Explanation regarding non-entity assets**

If not, does the Board wish to briefly describe current practice in the basis for conclusion and endorse it as adequate (that is, that related party disclosures regarding intra-governmental transactions are not needed and why)?

²Per the issue paper, staff recommends requiring items a, b, and c in Note 1 – Summary of Significant Accounting Policies.

NEXT STEPS

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

We have revised our goal of completing the ED by the August 2012 meeting due to the consideration of significant changes to the non-core entity disclosures. Completing the ED by the October 2012 meeting is the new goal and also may be contingent on the Board's views regarding related party or new issues in this area.

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 with a cc to paynew@fasab.gov.

QUESTIONS FOR THE BOARD

Question 1: Does the Board generally agree with the Staff Recommendation for Related Party?

Question 2: Does the Board generally agree with the proposed language for the ED?

Question 3: Does the Board believe 'Note 1' should include certain minimum information regarding the CRE's status as a component of the U.S. government?

Question 4: If so, does the Board believe information regarding any of the following should be required as part of an integrated discussion of the entity's status as a component of the U.S. government:

- f. Notice that the CRE is a component of the U. S. government, a sovereign entity**
- g. Discussion of going concern (need for continued authorizations and appropriations)**
- h. Discussion of costs not included in CRE statements**
- i. Caution regarding ability to liquidate liabilities not covered by budgetary resources**
- j. Explanation regarding non-entity assets**

If not, does the Board wish to briefly describe current practice in the basis for conclusion and endorse it as adequate (that is, that related party disclosures regarding intra-governmental transactions are not needed and why)?

Related Party Issue Paper

Issue 1: Related Party Recommendation for ED

The Board discussed related party in June 2011 but the Board decided it would “determine at a later date—after the remaining portions of the standards are completed— if the related party issue will be addressed in the entity project.”¹ The Board had noted that many of the currently reported related parties—such as the Federal Reserve and Amtrak may be considered non-core entities under the proposed standards. Some members wondered if there would be need for the category. Other members believed it should still be addressed in a concise manner once the other aspects of the standards were finalized.

Based on previous meetings, the Board:

- decided against adopting the AICPA auditing literature (i.e, the FASB standard) regarding related parties essentially “as is” because the AICPA language for related parties was not readily adaptable to the federal government environment and may not have provided the federal financial reporting community with meaningful guidance. .
- agreed tentatively that the focus of related parties should be on those entities outside the federal government and not on those within the federal government as existing guidance covers reporting of intra-governmental transactions.
- questioned (not all members, just certain members) if there was need for the related party category because there appeared to be difficulty coming up with potential examples. Further, Related Parties reported in previous CFRs, such as the Federal Reserve and Amtrak, may at a minimum be considered non-core in future years based on the new proposal.

For the June meeting, staff hopes to identify appropriate objectives of related party reporting by the federal government and obtain member input on options for meeting those objectives

Background and Existing Guidance (More complete background information was provided in the June 2011 Briefing Materials and is included as Appendix 2. Staff provides a brief summary of objectives below.)

Consideration of Objectives Established by Other Standards-Setters

Staff considered Related Party standards of other standard setters. The full text of the Governmental Accounting Standards Board (GASB), International Public Sector Accounting Standards Board (IPSASB), and Financial Accounting Standards Board (FASB) standards are included at Appendix 1 to this paper.

¹ Excerpt from June 2011 Minutes Conclusion.

The objectives of GASB's related party requirements appear to be (see Appendix 1 for full text):

1. ensure transactions are accounted for at amounts consistent with arms-length transactions (e.g., to avoid understating costs or asset values)
2. allow for the fact that governments often engage in transactions at non-arms-length amounts (e.g., non-exchange transactions) and provide that amounts for these transactions need not be adjusted

The IPSASB objectives include giving readers a better understanding of influences weighing on the reporting entity, risks and opportunities resulting from relationships, and reported results that may be over or understated as a result of other than arms-length transactions. These objectives are broad and led to a Related Party definition addressing entities with significant influence which include associates, individuals, key management and close members of the family of key management personnel, etc.

The FASB standards regarding related party transactions do not identify objectives directly. Nonetheless, the PCAOB literature provides insight from the audit perspective for its domain. PCAOB states in its Release 2012-001 (February 28, 2012) that:

Transactions with related parties can pose significant risks of material misstatement, as their substance might differ materially from their form. Related party transactions not only may involve difficult measurement and recognition issues that can lead to errors in financial statements but also, in some instances, related party transactions have been used to engage in financial statement fraud and asset misappropriation.

Staff Analysis of Objectives

Staff believes the most difficult part may be honing the objective of related party reporting in the federal government because of its unique and diverse relationships as well as the extensive intra-governmental relationships. It may be helpful to develop an all inclusive list of objectives from the other standards-setters and consider how the objectives relate to the U.S. federal government domain. The objectives are:

- Avoid, or reveal the potential for, material misstatement as a result of other than arms-length transactions by focusing on the substance rather than the legal form of a transaction
- Reveal relationships that may create an opportunity for fraudulent activity
- Provide a better understanding of influences on the reporting entity
- Explain risks and opportunities resulting from relationships

Staff believes primary objectives regarding identification of related parties in the federal government involve identifying and reporting risks, opportunities, and influences that would not be expected in the normal operations of the federal government or would not be expected to be assumed in arms length operating relationships. Objectives

regarding material misstatements and the potential for fraudulent activity are unlikely to be effectively addressed through related party reporting because of the nature and extent of federal government activities. The nature of the activities mean that many transactions are not arms length because the government is acting to achieve public policy goals. Further, revealing the potential for fraudulent activities – while an important consideration for auditors – is unlikely to be accomplished through financial statement disclosures due to the sheer size of the federal government.

Staff proposes the following objective:

Identify parties not controlled or owned by the federal government where an existing relationship may influence the federal government and/or implies the federal government has broadly assumed risk, or will in the future, that would not be expected to be assumed in arms length operating relationships. This assumption of risk is a result of the federal government's relationship with and ability to exercise significant influence over another organization.

Staff believes because related party reporting is a fundamental notion within GAAP and the auditing standards it is important to address related party concepts in the federal domain. Absent a clear articulation of related party concepts, we may find the private sector concepts applied by default. This is the present circumstance and staff believes application is inconsistent from entity to entity.

Further, staff strongly believes there is a need for the related party category so that relationships where there is significant influence are disclosed. Such organizations do not meet the requirements for inclusion in the GPFFR (ie. Inclusion principles) but significant influences may exist and be relevant to meeting the stewardship reporting objective. That objective is to 'assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future.'

Related party also should be addressed because one can't anticipate all types of relationships the federal government may have or might have in the future that need to be reported. The standard needs to address things that may not fit the criteria for core and non-core, specifically those relationships where there may be a level of influence but not control or ownership. Therefore, there should be provisions for how to report those types of organizations that fall outside core and non-core.

As noted above, a key concern with members was whether there was the need for the category because of the difficulty in coming up with potential examples. Staff understands the importance of considering potential related party relationships as a test of the proposals. Staff also notes that in determining potential related parties, one must consider the affects of the new standard—previously reported related parties may be considered core or non-core. One would only be able to include as a "related party" those entities that were not included in the GPFFR based on the inclusion principles.

Attachment 1--Tab D Federal Reporting Entity Related Party Issue Paper

Further, when considering the universe of entities the federal government has relationships with and the exercise of significant influence, there are seemingly countless types of entities and relationships that would have to be considered; making related parties a seemingly infinite pool. For example:

1. collaboration between federal and state/local governments on programs (e.g., job training programs or Medicaid experimentation) and acceptance of a portion of the cost of programs (e.g, through unfunded mandates or direct cost-sharing agreements)
2. “special interest groups” and industries that lobby elected officials
3. treaties that define common goals and means for joint action (e.g., NATO)
4. trade agreements
5. government-sponsored enterprises (for example, the Federal Home Loan Bank system)
6. organizations administering international cooperative efforts such as multilateral development banks

In considering the related party objectives of other standards setters, staff kept the above factors in mind and made changes in recognition of the federal environment. In that consideration, one understands the importance in business and commerce of drawing attention to the possibility that profit and loss may have been affected by the existence of the related party relationships and the underlying information (reliability, completeness, validity, comparability) to ensure it is arms-length.

However, the objective of relationships that the federal government enters into and the resulting transactions and thereby the objectives for related party reporting, are far different. Often it is not clear which party is at an advantage in relation to the federal government because the federal government is not routinely seeking profit when it enters such relationships or transaction with others. Often, the entire effect of the relationship or transaction cannot be clearly expressed in financial terms. The purpose of most of these relationships is to fulfill public policy goals and society needs.

Therefore, when one considers the federal government’s role and its potential ‘related party relationships’ parameters are needed to avoid focusing on many relationships that may not relate to appropriate objectives for related party reporting. Unless parameters were developed to exclude classes or to identify specific types of relationships for reporting, it would be a very difficult task to identify all the related parties of the federal government.

Additionally, the cost of meeting this type of requirement and related disclosure would be high; the benefit of including an extensive amount of information would be lost because users would be overwhelmed. For example, staff believes there would be a vast number of related parties reported including other countries, NATO, health care systems, treaties, United Nations, and many military and other contractors, etc. Staff does not believe the Board intends such a broad approach and we have not developed

an option that would encompass all the entities having influential relationships with the federal government.

As noted above staff believes, because the purpose of most of these relationships is for the good of the nation or to fulfill public policy, parameters are needed to avoid focusing on many relationships that may not relate to appropriate objectives for related party reporting. Therefore, staff believes states and other national governments should not be reported as related parties. In addition, key executives and other employees should be excluded.

Staff considered two potential candidates from the list above in greater detail--Government Sponsored Enterprises and Multilateral Development Banks. See **Attachment 2-- *Analysis of GSEs and MDBs***. Based on that analysis, there appear to be potential candidates for related party disclosure or at a minimum staff believes enough to warrant the standard providing for a related party disclosure. The relationships illustrate the wide variety of other relationships that exist with significant influence that may need to be considered for related party reporting.

Further, as staff noted above—staff believes the standard should provide for and offer a place for those organizations that, while not meeting the inclusion principles, still have a strong relationship warranting disclosure so that a better understanding of the risks and influences is possible. It is difficult to anticipate all potential relationships and organizations that may exist or might exist in the future. Instead a principles based standard should provide for those situations.

Staff believes the most important disclosure would be to report the nature of the relationship and any potential risks and exposures. The disclosures would not be as extensive as for non-core entities.

Staff also believes the government-wide and component reporting entity should apply the same standards though the materiality is different and therefore not all related parties would be included at the consolidated government-wide level.

Staff Recommendation

Staff believes the best approach is to:

1. Modify the other standards setters' language as necessary to fit the federal government environment for the reasons discussed in the staff analysis.

Alternatively, the Board may wish to:

2. Allow Risk Assumed Project to address the need for disclosures and do not define Related Party in the Federal Reporting Entity Project (this would continue the current practices of applying other literature through the GAAP hierarchy).

Staff recommendation is Option 1. Option 1 will provide users with information about the objective of related party reporting in the federal government while maintaining a definition that is based on significant influence. Staff proposes the following language for the ED:

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 accountable², the federal government may have existing relationships with organizations where the federal government has broadly assumed risk that would not be expected to be assumed in arms length operating relationships.
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 relationship³ 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, usually 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 solely from regulatory actions or economic dependency. However, 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 economic dependence on a relationship.

² 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.

³ Staff note: In past meetings, members have indicated that the federal government is not influenced by other parties and, therefore, related parties should be those influenced by the federal government. Staff believes the relationships needed in cooperative efforts—those relying on non-federal parties to accomplish federal missions—create influence. For example, failure of a non-federal entity where a substantial cooperative relationship exists may influence federal financial and operating decisions.

5. 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.
6. The objective of related party reporting in the federal government is to identify risks and influences that would not be expected to be assumed in arms length operating relationships. The federal government enters into relationships for the good of the nation or to fulfill public policy goals and societal needs. As a result, many complex relationships exist where significant influence is exerted. Judgment will be required to identify relationships that are not routine and may pose risks or introduce influences that warrant disclosure. In the context of this Statement, the following would not *generally* constitute significant influence or be considered related parties:
 - a. 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
 - b. Key executives or other employees
 - c. Component entities of the federal government see full discussion in par. 8
 - d. Foreign governments
7. Although par. 6 *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 objectives of related party disclosures.
8. Although significant influence exists among the component reporting entities of the federal government, component reporting entities are

Attachment 1--Tab D Federal Reporting Entity Related Party Issue Paper

subject to the overall direction and operate together to achieve the policies of the federal government and are not considered related parties.

9. 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.

QUESTIONS:

If the Board approves of the general provisions, staff would confer with the task force and other practitioners regarding the wording of exclusions. The consultation should provide a clearer sense of the effect and implementation challenges.

Does the Board generally agree with the Staff Recommendation for Related Party?

Does the Board generally agree with the proposed language for the ED?

Issue 2: Component Reporting Entity Issue

Related Party – One Component of a Sovereign Government

The Board previously discussed intra-governmental transactions and decided (1) existing inter-entity cost recognition requirements and (2) classification of amounts as intra-governmental adequately address such transactions. Mr. Dacey raised the concern that readers may need additional contextual information to understand component reporting entity (CRE) information. Proper context may require informing the readers that:

1. The CRE is a component of the U.S. Government, a sovereign entity.
2. The CRE operates within the parameters established by the Congress and the President. It is a going concern only to the extent that authorizing legislation permits it to operate and appropriations provide funding. (Note: Staff will consider

- whether alternative wording, or an exemption, is needed for some core entities.)
3. Liabilities not covered by budgetary resources⁴ cannot be liquidated without legislation that provides the resources to do so.
 4. Non-entity assets⁵ are not available for use by the CRE.
 5. Costs for broad and general support services provided by another component reporting entity to all or most other entities are not included in the CRE's cost of operations or output unless such services form a vital and integral part of those operations or output. As a result, reported costs do not include those costs incurred:
 - a. to finance general debt obligations of the U. S. Government (except for interest expense relating to financing of direct loans and loan guarantees),
 - b. for central payment services such as transferring funds to vendors and beneficiaries,
 - c. for executive functions such as central budget coordination, and
 - d. for other broad and general support services.

Current Practice

FASAB has not established requirements for a description of the entity other than the discussion of the organization and mission required in the Management's Discussion and Analysis section (MD&A). Nonetheless, most of the above points are addressed individually in agency MD&A and notes either as a result of existing standards, OMB form and content requirements, or voluntary agency efforts.

OMB Circular A-136, *Financial Reporting Requirements* (Section II.2.10, Limitations of the Financial Statements), requires that each agency include the following statement in its MD&A:

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Further, the circular requires that note 1, significant accounting policies, present a description of the reporting entity and identify its major components as well as a summary of the significant accounting principles and methods management has applied. Circular A-136 also directs agencies to "provide other information needed to understand

⁴ Liabilities not covered by budgetary resources include liabilities incurred for which revenues or other sources of funds necessary to pay the liabilities have not been made available through congressional appropriations or current earnings of the reporting entity. Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress. (Adapted from OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements.") (SFFAS 5, Summary)

⁵ Non-entity assets are those assets that are held by an entity but are not available to the entity. An example of non-entity assets are customs duty receivables that the Customs Service collects for the U.S. government but has no authority to spend. (SFFAS 1, par. 25) Non-entity assets are presented on the balance sheet and disclosure of the amount is required. An intra-governmental liability is recognized since non-entity assets must be transferred to another federal entity.

the nature of liabilities not covered by budgetary resources....and the “nature of non-entity assets.”

As a result, agencies have included the statement as well as sometimes adding explanatory text. Placement of the information varies slightly among the sample staff reviewed. Some place the statement only in the MD&A and others also include it in note

1. The following statements provide examples of relevant text from PARs and AFRs:

1. **Agriculture** – *MD&A* - The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Note 1 – inter-entity costs - Recognition of inter-entity costs that are not fully reimbursed is limited to material items that (1) are significant to the receiving entity, (2) form an integral or necessary part of the receiving entity’s output, and (3) can be identified or matched to the receiving entity with reasonable precision. Broad and general support services provided by an entity to all or most other entities should not be recognized unless such services form a vital and integral part of the operations or output of the receiving entity.

2. **Commerce** – *MD&A* - These financial statements should be read with the realization that they are for a component of the U.S. government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides the resources to do so.

Note 1, under liabilities - These are liabilities for which congressional actions are needed before budgetary resources can be provided. The Department anticipates that liabilities not covered by budgetary resources will be funded from future budgetary resources when required.

Note 1, under non-entity assets - Non-entity assets are assets held by the Department that are not available for use in its operations. Non-entity Fund Balance with Treasury includes customer deposits held by the Department until customer orders are received, and monies payable to the Treasury General Fund for custodial activity and for loan programs. Non-entity Direct Loans and Loan Guarantees, Net represents EDA’s Drought Loan Portfolio. The Portfolio collections are submitted to Treasury monthly.

3. **HHS** – *MD&A* - These statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation providing us with resources and budget authority.

Note 1 - The Department of Health and Human Services (HHS) is a Cabinet-level agency of the executive branch of the federal government. These statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be

liquidated without legislation providing resources and budget authority for the HHS.....

Note 1 – under liabilities - Since the HHS is a component of the U.S. Government, a sovereign entity, its liabilities cannot be liquidated without legislation that provides resources to do so.

Note 1 under Non-entity assets - Non-entity assets are assets held by the reporting entity, but not available for use. HHS has non-entity assets that are comprised of delinquent child support payments for the Child Support Enforcement Program, which are withheld from federal tax refunds, and interest accrued on over-payments and cost settlements reported by the Medicare contractors.

Note 1 - Intra-governmental Transactions and Relationships - Intra-governmental transactions are transactions between federal entities, meaning both the buyer and seller are federal entities. Transactions with the public are transactions in which either the buyer or seller of the goods or services is a non-federal entity. If a federal entity purchases goods or services from another federal entity and sells them to the public, the exchange revenue is classified as with the public, but the related costs would be classified as intra-governmental. The purpose of the classifications is to enable the federal government to provide consolidated financial statements, and not to match public and intra-governmental revenue with costs incurred to produce public and intra-governmental revenue. In the course of operations, the HHS has relationships and financial transactions with numerous federal agencies. The more prominent of these relationships are with the SSA and the Treasury. The SSA determines eligibility for Medicare programs and also deducts Medicare Part-B premiums from Social Security benefit payments and allocates those funds to the Medicare Part-B Trust Fund for Social Security beneficiaries who elect to enroll in the Medicare Part-B program. The Treasury receives the cumulative excess of Medicare receipts and other financing over outlays and issues interest-bearing securities in exchange for the use of those monies. Medicare Part-D is primarily financed by the General Fund of the Treasury and beneficiary premiums.

4. **Justice** – *MD&A* - The statements should be read with the realization that they are for a component of the United States Government, a sovereign entity.

Note 1 regarding liabilities - Liabilities represent the monies or other resources that are likely to be paid by the Department as the result of a transaction or event that has already occurred. However, no liability can be paid by the Department absent proper budget authority. Liabilities that are not funded by the current year appropriation are classified as liabilities not covered by budgetary resources in Note 11.

Note 1 regarding non-entity assets - Non-entity assets are not available for use by the Department and consist primarily of restricted undisbursed civil and criminal debt collections, seized cash, accounts receivable, and other monetary assets.

Note 19 – Imputed Costs - SFFAS No. 4 also states that costs for broad and general support need not be recognized by the receiving entity, unless such services form a vital and integral part of the operations or output of the receiving entity. Costs are considered broad and general if they are provided to many, if not all, reporting components and not specifically related to the receiving entity's output.

5. **NASA – Introduction to the Financial Statements** - The statements should be read with the understanding that they are for a component of the U.S. Government, a sovereign entity. NASA has no authority to pay liabilities not covered by budgetary resources. Liquidation of such liabilities requires enactment of an appropriation.

Note 1 - The financial statements should be read with the realization they are a component of the U.S. government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation providing resources and legal authority to do so. [Regarding liabilities...] Generally liabilities not covered by budgetary resources are liabilities for which congressional action is needed before budgetary resources can be provided. Liabilities not covered by budgetary resources include certain environmental matters, legal claims, pensions and other retirement benefits, workers' compensation, annual leave, and closed appropriations.

Note 2 – Non-entity assets - The majority of NASA's assets are considered entity assets. Non-entity assets represent amounts held by NASA on behalf of the U.S. Treasury that are not available for use by NASA.

6. **SSA – MD&A** – The financial statements should be read with the realization they are for a component of the U.S. government, a sovereign entity. *Note 3 – Non-entity Assets* -are those assets that are held by the entity, but are not available to the entity.

Staff Analysis and Recommendation:

Current practice has evolved to cover certain aspects of agencies' status as components of a sovereign entity. The information currently provided results from individual standards and OMB's establishment of form and content as well as agency efforts. However, the explanatory material could be improved by integrating some of the information and by filling some gaps in information.

Attachment 1--Tab D Federal Reporting Entity Related Party Issue Paper

Staff believes the description of the entity presented in Note 1 should include, at a minimum, an explanation that the CRE is a component of the U.S. government and a discussion of going concern implications arising from that status. For example, the note might explain that the CRE operates within the parameters established by the Congress and the President and is a going concern only to the extent that authorizing legislation permits it to operate and appropriations provide funding. It would also be helpful to include information regarding those inter-entity costs- broad and general support costs- not included in CRE statements.

While there are differences in the example explanations regarding liabilities not covered by budgetary resources and non-entity assets, staff believes allowing such differences is consistent with permitting agencies to discuss “significant” accounting policies.

If the Board accepts the staff recommendation that intra-governmental relationships be excluded from “related parties” and does not wish to establish additional Note 1 requirements, it would be appropriate to explain why in the basis for conclusions.

Questions for the Board:

Does the Board believe ‘Note 1’ should include certain minimum information regarding the CRE’s status as a component of the U.S. government?

If so, does the Board believe information regarding any of the following should be required as part of an integrated discussion of the entity’s status as a component of the U.S. government:

- a. Notice that the CRE is a component of the U. S. government, a sovereign entity**
- b. Discussion of going concern (need for continued authorizations and appropriations)**
- c. Discussion of costs not included in CRE statements**
- d. Caution regarding ability to liquidate liabilities not covered by budgetary resources**
- e. Explanation regarding non-entity assets**

If not, does the Board wish to briefly describe current practice in the basis for conclusion and endorse it as adequate (that is, that related party disclosures regarding intra-governmental transactions are not needed and why)?

Attachment 2-- Attachment 2 Analysis of GSEs and MDBs

Consideration of Government Sponsored Enterprises

Background

Government Sponsored Enterprises (GSEs) are defined by Congress in enabling legislation. Congress defined the term GSE for budgetary purposes in the Omnibus Reconciliation Act of 1990 as

- a corporate entity created by a law of the United States that —
 - (A) (i) has a Federal charter authorized by law;
 - (ii) is privately owned, as evidenced by capital stock owned by private entities or individuals;
 - (iii) is under the direction of a board of directors, a majority of which is elected by private owners;
 - (iv) is a financial institution with power to —
 - (I) make loans or loan guarantees for limited purposes such as to provide credit for specific borrowers or one sector; and
 - (II) raise funds by borrowing (which does not carry the full faith and credit of the Federal Government) or to guarantee the debt of others in unlimited amounts; and
 - (B) (i) does not exercise powers that are reserved to the Government as sovereign (such as the power to tax or to regulate interstate commerce);
 - (ii) does not have the power to commit the Government financially (but it may be a recipient of a loan guarantee commitment made by the Government); and
 - (iii) has employees whose salaries and expenses are paid by the enterprise and are not Federal employees subject to title 5.⁶

Some have argued that the above definition omits an essential characteristic — a GSE “benefits from an implicit federal guarantee to enhance its ability to borrow money.”⁷

Congress created GSEs to help make credit more readily available to sectors of the economy believed to be disadvantaged in the credit markets. The Federal Agricultural Mortgage Corporation (Farmer Mac) is investor owned. [NOTE: Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) were investor owned but now are in federal conservatorship.]

⁶ 104 Stat. 1388-607, Sec. 13112; 2 U.S.C. 622(8)

⁷ *The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics*, CRS Report for Congress RL30533

The Federal Home Loan Bank System and the Farm Credit System — are owned cooperatively by their borrowers. The Financing Corporation and the Resolution Funding Corporation are also organizations that were given GSE status.

It should be noted that one well-known GSE, Sallie Mae (Student Loan Marketing Association) recently shed its GSE status and become a wholly private firm.⁸

Relationship/ Influence

While the details may vary from one to the next, the Congressional Research Service reports that GSEs typically have four characteristics: private ownership; implicit federal guarantee of obligations; activities limited by congressional charter; and limited competition.⁹

GSEs are federally chartered but established to be privately owned and operated financial institutions that are authorized to make loans or loan guarantees for limited purposes. However, the key is that Congress creates these quasi-public entities for specific public policy purposes.

GSEs generally have a nationwide scope, and they benefit from the market perception of an implied federal guarantee. Further, they are regulated by specialized federally created entities (the Federal Housing Finance Agency and the Farm Credit Administration), in addition to other federally created entities that regulate corporations generally and state regulatory agencies.¹⁰

For example, the Federal Housing Finance Agency (FHFA), was granted broad supervisory and regulatory powers, including the new authority to set risk-based capital requirements, liquidate an FHLBank, or act as either a conservator or a receiver of an FHLBank facing potential insolvency. The FHFA Director is a presidential appointee subject to Senate confirmation, who serves a five year term and holds broad discretion over the regulation of the housing financing industry. Similar to the Federal Reserve System, the FHLBank system consists of 12 regional member-owned and federally chartered banks, each with its own individual board of directors.¹¹

Although a federally chartered organization generally receives increased governmental supervision and cannot bind the government in any way, Congressional sponsorship brings with it the authority to exercise specifically enumerated governmental powers and a number of significant financial benefits. For instance, the FHLBank system enjoys a variety of special privileges such as exemption from federal, state, and local income tax.¹²

⁸ Ibid

⁹ Ibid

¹⁰ GAO-10-97 *Federally Created Entities : An Overview of Key Attributes*

¹¹ *The Federal Home Loan Bank System and Resolution of a Failure*, CRS Report for Congress R41102

¹² Ibid

Risks and Exposures

While GSEs were chartered as privately owned and the federal government explicitly does not guarantee their debt obligations, investors and other interested parties have widely assumed that if GSEs faced a financial emergency they would receive some form of federal support.

In September 2008, federal support was, in fact, provided to Fannie Mae and Freddie Mac. Out of concern that their deteriorating financial condition would threaten the stability of financial markets, the Federal Housing Finance Agency, an executive branch entity, placed Fannie Mae and Freddie Mac into conservatorship, and the Department of the Treasury, an executive department, agreed to use its appropriated funds to provide financial support by committing to purchase preferred stock in each GSE to maintain their positive net worth.¹³

In addition, the Department of the Treasury and the Board of Governors of the Federal Reserve System agreed to purchase the various GSE-related debts and securities to support housing finance, housing markets, and, more generally, the financial markets.

When considering the FHLBanks, the fundamental characteristic that allows the FHLBanks to provide low interest loans to member institutions is their collective status as a “government-sponsored enterprise.” GSEs can only purchase mortgages that have already been originated and either borrowing funds to hold the mortgages or packaging the mortgages into mortgage-backed securities (MBS). These MBS can be either held by the GSEs or sold to investors.¹⁴

Perhaps the most important benefit enjoyed by the FHLBank, however, is the so-called implicit guarantee that the federal government backs FHLBank obligations. The value of this implicit guarantee is, however, ambiguous.¹⁵

For example, because of this implicit federal guarantee on FHLBank debts, FHLBank securities are considered to have little to no risk and regional FHLBanks can borrow funds from investors at very low interest.¹⁶

¹³ GAO-10-97 *Federally Created Entities : An Overview of Key Attributes* and GAO-09-782 *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*,

¹⁴ *The Federal Home Loan Bank System and Resolution of a Failure*, CRS Report for Congress R41102

¹⁵ Ibid

¹⁶ Ibid

Consideration of Multilateral Development Banks¹⁷

Background

The multilateral development banks (MDBs) include the World Bank¹⁸ and four smaller regional development banks: the African Development Bank (AfDB), the Asian Development Bank (AsDB), the European Bank for Reconstruction and Development (EBRD), and the Inter-American Development Bank (IDB). The United States is a member of, and major donor to, each of the MDBs. Other top donors include Western European countries, Japan, and Canada. Additionally, several regional members have large financial stakes in the regional banks. For example, among the regional members, China and India are large contributors to the AsDB; Egypt and South Africa are large contributors to the AfDB; Argentina, Brazil, and Venezuela are large contributors to the IDB; and Russia is a large contributor to the EBRD.

The MDBs provide financial assistance to developing countries in order to promote economic and social development. They primarily fund large infrastructure and other development projects and, increasingly, provide loans tied to policy reforms by the government. Due to the financial backing of their member country governments, the MDBs are able to borrow money in world capital markets at the lowest available market rates, generally the same rates at which developed country governments borrow funds inside their own borders.

Most of the MDBs have two funds, often called lending windows or lending facilities. One type of lending window is used to provide financial assistance on market-based terms, typically in the form of loans, but also through equity investments and loan guarantees. The MDBs provide non-concessional financial assistance to middle-income countries and some creditworthy low-income countries on market-based terms. The other type of lending window is used to provide financial assistance at below market-based terms (concessional assistance), typically in the form of loans at below-market interest rates and grants, to governments of low-income countries.

Financial assistance from the MDBs to emerging economies is somewhat controversial. Some argue that, instead of using MDB resources, these countries

¹⁷ All information in the *Consideration of Multilateral Development Banks* was taken from the CRS Report for Congress RL41170 *Multilateral Development Banks: Overview and Issues for Congress*

¹⁸ The World Bank is the oldest and largest of the MDBs. The World Bank Group comprises three sub-institutions that make loans and grants to developing countries: the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), and the International Finance Corporation (IFC)

should rely on their own resources, particularly countries like China which has substantial foreign reserves holdings and can easily get loans from private capital markets to fund development projects. MDB assistance, it is argued, would be better suited to focusing on the needs of the world's poorest countries, which do not have the resources to fund development projects and cannot borrow these resources from international capital markets.

Relationship/ Influence

The MDBs have similar internal organizational structures. Run by their own management and staffed by international civil servants, each MDB is supervised by a Board of Governors and a Board of Executive Directors. The Board of Governors is the highest decision-making authority, and each member country has its own governor¹⁹. While the Boards of Governors in each of the Banks retain power over major policy decisions, such as amending the founding documents of the organization, they have delegated day-to-day authority over operational policy, lending, and other matters to their institutions' Board of Executive Directors.

Cumulatively, the United States has the largest financial commitments to the non-concessional lending windows at the IBRD, the IFC, the IDB, and the EBRD. At the AfDB, the United States has the second largest financial commitment after Nigeria. At the AsDB, the United States is tied with Japan for the largest financial commitment.

Decisions are reached in the MDBs through voting.

Each member country's voting share is weighted on the basis of its cumulative financial contributions and commitments to the organization. The voting power of the United States is large enough to veto major policy decisions at the World Bank and the IDB, such as amending the World Bank's Articles of Agreement. However, the United States cannot unilaterally veto more day-to-day decisions, such as individual loans. The United States voting power in the MDBs (bank followed by US %): *World Bank Group 2011--* IBRD 16.05%, IDA 11.03%, and IFC 23.59% *Regional Banks, 2010--* AfDB 6.415%, AfDF 5.735%, AsDB 5.025%, EBRD 10.138%, and IDB 30.006%.

In addition to congressional hearings on the MDBs, Congress exercises oversight over U.S. participation in the MDBs through legislative mandates. These mandates direct the U.S. Executive Directors to the MDBs to advocate certain policies and how to vote on various issues at the MDBs.

Congress plays an important role in determining U.S. funding for the MDBs and engaging in oversight of the Administration's participation in the MDBs. In addition to

¹⁹ The United States is currently represented by Treasury Secretary Timothy Geithner.

congressional hearings on the MDBs, Congress has enacted a substantial number of legislative mandates that oversee and regulate U.S. participation in the MDBs. These mandates generally fall into one of four major types:

- numerous legislative mandates direct how the U.S. representatives at the MDBs can vote on various policies.
- legislative mandates direct the U.S. representatives at the MDBs to advocate for policies within the MDBs.
- Congress has also passed legislation requiring the Treasury Secretary to submit reports on various MDB issues (reporting requirements).
- Congress has also attempted to influence policies at the MDBs through “power of the purse,” that is, withholding funding from the MDBs or attaching stipulations on the MDBs’s use of funds.

The executive branch and Congress share responsibility for U.S. policy towards the MDBs and each has primary control over a different part of the policy process. The Administration is responsible for negotiating with other countries and for managing day-to-day U.S. participation in the MDBs. Congress has ultimate authority over the level of U.S. financial commitments and the criteria that govern U.S. participation in these institutions. Congress has authorized the President to direct U.S. participation in the MDBs, and the President has delegated that authority to the Secretary of the Treasury. Other agencies also have reasons for being concerned about U.S. policy and the MDBs. The Administration created a new process, starting in 2009, to help coordinate interagency views on MDB issues.

Risks and Exposures

Congressional interest in the MDBs has increased since the outbreak of the current global financial crisis. Following the onset of the crisis in the fall of 2008, the MDBs ramped up financial assistance to developing countries. As a consequence, each of the MDBs has requested increased funding from their member states in order to increase lending to middle-income countries.

The U.S. is the top donor in almost every developmental bank. Any U.S. financial contribution to the MDBs requires congressional authorization and appropriation legislation. Appropriations for the concessional windows occur regularly, but appropriations are far more infrequent for the nonconcessional windows. Unusually, all the MDBs are in the process of increasing the size of their non-concessional lending facilities. Congress authorized U.S. contributions to the “general capital increases” of the non-concessional lending windows in FY2011 for the AsDB and in FY2012 for the other MDBs. The appropriations for these increases are expected to be spread out over a five- to eight-year period, depending on the institution.

The MDBs' concessional aid programs are funded with money donated by their wealthier member country governments. Loans from the MDBs' market-rate loan facilities are funded with money borrowed in world capital markets. The IFC and IIC fund their loans and equity investments partly with money contributed by their members and partly with funds borrowed from commercial capital markets. The MDBs' borrowings are backed by the subscriptions of their member countries. They provide a small part of their capital subscriptions (3% to 5% of the total for most MDBs) in the form of paid-in capital. The rest they subscribe as callable capital. Callable capital is a contingent liability, payable only if an MDB becomes bankrupt and lacks sufficient funds to repay its own creditors. It cannot be called to provide the banks with additional loan funds.

Another point worth noting is that billions of dollars of contracts are awarded to private firms each year in order to acquire the goods and services necessary to implement projects financed by the MDBs. U.S. commercial interest in the MDBs has been and may continue to be a subject of Congressional attention, particularly if the banks expand their lending capacity for infrastructure projects

Note: Staff has not assessed existing information from Treasury's agency financial report to determine what – if anything would change – if MDBs were considered related parties. Nor should the above analysis be construed to suggest that staff believes current disclosures are deficient. For members information, selected excerpts from the existing notes are provided below (the investment note was excluded and reflects amounts invested in each MDB). In addition, Treasury's MD&A describes its accomplishments in working with and through the MDBs.

Note 1, *Investments in International Financial Institutions* - The Department, on behalf of the United States, invests in Multilateral Development Banks (MDBs) to support poverty reduction, private sector development, transitions to market economies and sustainable economic growth and development, thereby advancing the United States' economic, political, and commercial interests abroad. As a participating member country, the Department, on behalf of the United States, provides a portion of the capital base of the MDBs, through subscriptions to capital, which allows the MDBs to issue loans at market-based rates to middle income developing countries. These paid-in capital investments are considered non-marketable equity investments valued at cost on the Department's Consolidated Balance Sheets.

In addition, the Department, on behalf of the United States, contributes funding to MDBs to finance grants and extend credit to poor countries at below market-based interest rates. These U.S. contributions are reported as an expense on the Department's Consolidated Statements of Net Cost.

Note 28: Commitments and Contingencies

Multilateral Development Banks

The Department on behalf of the United States has subscribed to capital for certain multilateral development banks (MDBs), portions of which are callable under certain limited circumstances to meet the obligations of the respective MDB. There has never been, nor is there anticipated, a call on the U.S. commitment for these subscriptions. As of September 30, 2011 and 2010, U.S. callable capital in MDB was as follows (in millions):

	2011
	2010
[Detail omitted]	
Total	\$ 72,038
\$ 63,864	

Amounts included in the above table do not include amounts for which the Department may be liable to pay if future congressional action is taken to fund executed agreements between the Department and certain multilateral development banks.

In accordance with the disclosure requirements of SFFAS No. 5 "Accounting for Liabilities of the Federal Government", an increase of \$5.7 billion in callable capital of the International Bank for Reconstruction and Development (IBRD) was made to reflect the Department's authorization to use a public debt transaction in the United States' original subscription to capital stock of the IBRD. In prior years, this amount had not been presented as a commitment.

Additionally, the Department recorded callable capital in fiscal year 2007 for the African Development Bank (AfDB), European Bank for Reconstruction and Development (EBRD) and the Multilateral Investment Guarantee Agency (MIGA) as a result of a full year Continuing Appropriation Resolution (PL 110-5) which was based on fiscal year 2006 appropriation language authorizing callable capital. However, all outstanding commitments to the EBRD and the AfDB have been satisfied and to the extent that any outstanding authority exists, it is no longer necessary. In addition, Congress explicitly provided no appropriated funds for MIGA in fiscal year 2007 and no further callable commitments were made to MIGA in accordance with the intent of Congress. As a result, the callable capital for these financial institutions has been reduced to reflect the actual limitations imposed by Congress.

Appendix 1-- Text of GASB, IPSASB, and FASB *Related Party* standards

GASB

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

2. This Statement establishes accounting and financial reporting standards for related party transactions, subsequent events, and going concern considerations. This Statement applies to all state and local governments.

3. This Statement amends paragraph 26 of the National Council on Governmental Accounting (NCGA) Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*.

Related Party Transactions

4. State and local governments are required to disclose certain related party transactions. If the substance of a particular transaction is significantly different from its form because of the involvement of related parties, financial statements should recognize the substance of the transaction rather than merely its legal form.

5. Examples of transactions with related parties that have features that may indicate that governments should consider whether a *form-over-substance* condition exists include:

- a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction
- b. Selling real estate at a price that differs significantly from its appraised value
- c. Exchanging property for similar property in a nonmonetary transaction
- d. Making loans with no scheduled terms for when or how the loans will be repaid.

6. Determining the substance of a related party transaction may pose challenges not present in assessing transactions between unrelated parties. For example, a related party relationship may result in transactions that would not take place between unrelated parties or would be subject to different terms and conditions. In such cases, the substance of the related party transaction may differ from its legal form due to the related party relationship.

7. It may not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or what the terms and conditions would have been. Therefore, it may be difficult to determine whether a transaction was consummated on terms comparable to those that would be present in arm's-length transactions. Furthermore, governments frequently enter into transactions and engage in activities that are driven by societal needs and concern for the "public good." Therefore, it may not be appropriate to compare some governmental programs and arrangements to what might have occurred in an arm's-length transaction in the private sector or with unrelated parties.

IPSASB

IPSAS 20, *Related Party Disclosures*

Definition

Related party parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions or if the related party entity and another entity are subject to common control.

Related parties include:

- (a) Entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the reporting entity;
- (b) Associates (see IPSAS 7, “Investments in Associates”);
- (c) Individuals owning, directly or indirectly, an interest in the reporting entity that gives them significant influence over the entity, and close members of the family of any such individual;
- (d) Key management personnel, and close members of the family of key management personnel; and
- (e) Entities in which a substantial ownership interest is held, directly or indirectly, by any person described in (c) or (d), or over which such a person is able to exercise significant influence.

Related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. Related party transactions exclude transactions with any other entity that is a related party solely because of its economic dependence on the reporting entity or the government of which it forms part.

Significant influence (for the purpose of this Standard) 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, usually by representation on the board of directors or equivalent governing body but also by, for example, participation in the policy making process, material transactions between entities within an economic entity, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by an ownership interest, statute or agreement. With regard to an ownership interest, significant influence is presumed in accordance with the definition contained in IPSAS 7.

Related Parties

10. In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

11. Where two entities have a member of key management personnel in common, it is necessary to consider the possibility, and to assess the likelihood, that this person would be able to affect the policies of both entities in their mutual dealings. However, the mere fact that there is a member of key management personnel in common does not necessarily create a related party relationship.

12. In the context of this Standard, the following are deemed not to be related parties:

- (a) (i) Providers of finance in the course of their business in that regard; and
- (ii) Trade unions; in the course of their normal dealings with an entity by virtue only of those dealings (although they may circumscribe the freedom of action of an entity or participate in its decision-making process); and
- (b) An entity with which the relationship is solely that of an agency.

13. Related party relationships may arise when an individual is either a member of the governing body or is involved in the financial and operating decisions of the reporting entity. Related party relationships may also arise through external operating relationships between the reporting entity and the related party. Such relationships will often involve a degree of economic dependency.

14. Economic dependency, where one entity is dependent on another in that it relies on the latter for a significant volume of its funding or sale of its goods and services, would on its own be unlikely to lead to

control or significant influence and is therefore unlikely to give rise to a related party relationship. As such, a single customer, supplier, franchisor, distributor, or general agent with whom a public sector entity transacts a significant volume of business will not be a related party merely by virtue of the resulting economic dependency. However, 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 economic dependence on a relationship. Where the reporting entity is economically dependent on another entity, the reporting entity is encouraged to disclose the existence of that dependency.

15. The definition of related party includes entities owned by key management personnel, close family members of such individuals or major shareholders (or equivalent where the entity does not have a formal equity structure) of the reporting entity. The definition of related party also includes circumstances in which one party has the ability to exercise significant influence over the other party. In the public sector, an individual or entity may be given oversight responsibility for a reporting entity, which gives them significant influence, but not control, over the financial and operating decisions of the reporting entity. For the purposes of this Standard, significant influence is defined to encompass entities subject to joint control.

Remuneration of Key Management Personnel

16. Remuneration of key management personnel includes remuneration derived by individuals from the reporting entity for services provided to the reporting entity in their capacity as members of the governing body or employees. Benefits derived directly or indirectly from the entity for services in any capacity other than as an employee or a member of the governing body do not satisfy the definition of remuneration of key management personnel in this Standard. However, paragraph 34 requires disclosures to be made about certain of these other benefits. Remuneration of key management personnel excludes any consideration provided solely as a reimbursement for expenditure incurred by those individuals for the benefit of the reporting entity, such as the reimbursement of accommodation costs associated with work-related travel.

Voting Power

17. The definition of related party will include any individuals owning, directly or indirectly, an interest in the voting power of the reporting entity that gives them significant influence over the entity. The holding of an interest in the voting power of an entity can arise when a public sector entity has a corporate structure and a minister or government agency holds shares in the entity.

The Related Party Issue

18. Related party relationships exist throughout the public sector, because:

- (a) Administrative units are subject to the overall direction of the executive government and, ultimately, the Parliament or similar body of elected or appointed officials, and operate together to achieve the policies of the government;
- (b) Government departments and agencies frequently conduct activities necessary for the achievement of different components of their responsibilities and objectives through separate controlled entities, and through entities over which they have significant influence; and
- (c) Ministers or other elected or appointed members of the government and senior management group can exert significant influence over the operations of a department or agency.

19. Disclosure of certain related party relationships and related party transactions and the relationship underlying those transactions is necessary for accountability purposes and enables users to better understand the financial statements of the reporting entity because:

- (a) Related party relationships can influence the way in which an entity operates with other entities in achieving its individual objectives, and the way in which it co-operates with other entities in achieving common or collective objectives;
- (b) Related party relationships might expose an entity to risks or provide opportunities that would not have existed in the absence of the relationship; 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. This occurs frequently in government departments and agencies where goods and services are transferred between departments at less than full cost recovery as a part of normal operating procedures

consistent with the achievement of the objectives of the reporting entity and the government. Governments and individual public sector entities are expected to use resources efficiently, effectively and in the manner intended, and to deal with public monies with the highest levels of integrity. The existence of related party relationships means that one party can control or significantly influence the activities of another party. This provides the opportunity for transactions to occur on a basis that may advantage one party inappropriately at the expense of another.

20. Disclosure of certain types of related party transactions that occur and the terms and conditions on which they were conducted allows users to assess the impact of those transactions on the financial position and performance of an entity and its ability to deliver agreed services. This disclosure also ensures that the entity is transparent about its dealings with related parties.

Remuneration of Key Management Personnel

21. Key management personnel hold positions of responsibility within an entity. They are responsible for the strategic direction and operational management of an entity and are entrusted with significant authority. Their salaries are often established by statute or an independent tribunal or other body independent of the reporting entity. However, their responsibilities may enable them to influence the benefits of office that flow to them or their related parties. This Standard requires certain disclosures to be made about the remuneration of key management personnel and close members of the family of key management personnel during the reporting period, loans made to them and the consideration provided to them for services they provide to the entity other than as a member of the governing body or an employee. The disclosures required by this Standard will ensure that appropriate minimum levels of transparency are applied to the remuneration of key management personnel and close members of the family of key management personnel.

Materiality

22. IPSAS 1, “Presentation of Financial Statements” requires the separate disclosure of material items. The materiality of an item is determined with reference to the nature or size of that item. When assessing the materiality of related party transactions, the nature of the relationship between the reporting entity and the related party and the nature of the transaction may mean that a transaction is material regardless of its size.

Disclosure

23. In many countries, the laws, and other authoritative financial reporting rules, require financial statements of private sector entities and government business enterprises to disclose information about certain categories of related parties and related party transactions. In particular, attention is focused on the entity’s transactions with its directors or members of its governing body and with its senior management group, especially their remuneration and borrowings. This is because of the fiduciary responsibilities of directors, members of the governing body and senior management group, and because they have extensive powers over the deployment of entity resources. In some jurisdictions, similar requirements are included in the statutes and regulations applicable to public sector entities.

24. Some IPSASs also require disclosure of transactions with related parties. For example, IPSAS 1 requires disclosure of amounts payable to and receivable from controlling entities, fellow controlled entities, associates and other related parties. IPSAS 6, “Consolidated and Separate Financial Statements” and IPSAS 7 require disclosure of a list of significant controlled entities and associates. IPSAS 3, “Accounting Policies, Changes in Accounting Estimates and Errors” requires disclosure of extraordinary items and items of revenue and expense within surplus or deficit from ordinary activities that are of such size, nature or incidence that their disclosure is relevant to explain the performance of the entity for the period.

Disclosure of Control

25. **Related party relationships where control exists should be disclosed irrespective of whether there have been transactions between the related parties.**

26. In order for a reader of financial statements to form a view about the effects of related party relationships on a reporting entity, it is appropriate to disclose related party relationships where control exists, irrespective of whether there have been transactions between the related parties. This would involve the disclosure of the names of any controlled entities, the name of the immediate controlling entity and the name of the ultimate controlling entity, if any.

Disclosure of Related Party Transactions

27. In respect of transactions between related parties other than transactions that would occur within a normal supplier or client/recipient relationship on terms and conditions no more or less favorable than those which it is reasonable to expect the entity would have adopted if dealing with that individual or entity at arm's length in the same circumstances, the reporting entity should disclose:

- (a) The nature of the related party relationships;**
- (b) The types of transactions that have occurred; and**
- (c) The elements of the transactions necessary to clarify the significance of these transactions to its operations and sufficient to enable the financial statements to provide relevant and reliable information for decision making and accountability purposes.**

28. The following are examples of situations where related party transactions may lead to disclosures by a reporting entity:

- (a) Rendering or receiving of services;
- (b) Purchases or transfers/sales of goods (finished or unfinished);
- (c) Purchases or transfers/sales of property and other assets;
- (d) Agency arrangements;
- (e) Leasing arrangements;
- (f) Transfer of research and development;
- (g) License agreements;
- (h) Finance (including loans, capital contributions, grants whether in cash or in kind and other financial support including cost sharing arrangements); and
- (i) Guarantees and collaterals.

29. Public sector entities transact extensively with each other on a daily basis. These transactions may occur at cost, less than cost or free-of-charge. For example, a government department of administrative services may provide office accommodation free of charge to other departments, or a public sector entity may act as a purchasing agent for other public sector entities. In some models of government there may be the capacity for recovery of more than the full cost of service delivery. Departments are related parties because they are subject to common control and these transactions meet the definition of related party transactions. However, disclosure of information about transactions between these entities is not required where the transactions are consistent with normal operating relationships between the entities, and are undertaken on terms and conditions that are normal for such transactions in these circumstances. The exclusion of these related party transactions from the disclosure requirements of paragraph 27 reflects that public sector entities operate together to achieve common objectives, and acknowledges that different mechanisms may be adopted for the delivery of services by public sector entities in different jurisdictions. This Standard requires disclosures of related party transactions only when those transactions occur other than in accordance with the operating parameters established in that jurisdiction.

30. The information about related party transactions that would need to be disclosed to meet the objectives of general purpose financial reporting would normally include:

- (a) A description of the nature of the relationship with related parties involved in these transactions. For example, whether the relationship was one of a controlling entity, a controlled entity, an entity under common control, or key management personnel;
- (b) A description of the related party transactions within each broad class of transaction and an indication of the volume of the classes, either as a specific monetary amount or as a proportion of that class of transactions and/or balances;
- (c) A summary of the broad terms and conditions of transactions with related parties, including disclosure of how these terms and conditions differ from those normally associated with similar transactions with unrelated parties; and

(d) Amounts or appropriate proportions of outstanding items.

31. Paragraph 34 of this Standard requires additional disclosures to be made about certain transactions between an entity and key management personnel and/or the close members of the family of key management personnel.

32. Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary to provide relevant and reliable information for decision making and accountability purposes.

33. Disclosure of related party transactions between members of an economic entity is unnecessary in consolidated financial statements because consolidated financial statements present information about the controlling entity and controlled entities as a single reporting entity. Related party transactions that occur between entities within an economic entity are eliminated on consolidation in accordance with IPSAS 6. Transactions with associated entities accounted for under the equity method are not eliminated and therefore require separate disclosure as related party transactions.

Disclosure — Key Management Personnel

34. An entity shall disclose:

- (a) The aggregate remuneration of key management personnel and the number of individuals, determined on a full time equivalent basis, receiving remuneration within this category, showing separately major classes of key management personnel and including a description of each class;**
- (b) The total amount of all other remuneration and compensation provided to key management personnel, and close members of the family of key management personnel, by the reporting entity during the reporting period showing separately the aggregate amounts provided to:**
 - (i) Key management personnel; and**
 - (ii) Close members of the family of key management personnel; and**
- (c) In respect of loans which are not widely available to persons who are not key management personnel and loans whose availability is not widely known by members of the public, for each individual member of key management personnel and each close member of the family of key management personnel:**
 - (i) The amount of loans advanced during the period and terms and conditions thereof;**
 - (ii) The amount of loans repaid during the period;**
 - (iii) The amount of the closing balance of all loans and receivables; and**
 - (iv) Where the individual is not a director or member of the governing body or senior management group of the entity, the relationship of the individual to such.**

35. Paragraph 27 of this Standard requires the disclosure of related party transactions which have occurred other than on an arm's length basis consistent with the operating conditions established for the entity. This Standard also requires the disclosure of information about certain transactions with key management personnel identified in paragraph 34, whether or not they have occurred on an arm's length basis consistent with the operating conditions that apply in respect of the entity.

36. Persons who are key management personnel may be employed on a full or part time basis. The number of individuals disclosed as receiving remuneration in accordance with paragraph 34(a) needs to be estimated on a full time equivalent basis. Entities will make separate disclosures about the major classes of key management personnel that they have. For example, where an entity has a governing body that is separate from its senior management group, disclosures about remuneration of the two groups will be made separately. Where an individual is a member of both the governing body and the senior management group, that individual will be included in only one of those groups for the purposes of this Standard. The categories of key management personnel identified in the definition of key management personnel provide a guide to identifying classes of key management personnel.

37. Remuneration of key management personnel can include a variety of direct and indirect benefits. Where the cost of these benefits is determinable, that cost will be included in the aggregate remuneration is closed.

Where the cost of these benefits is not determinable, a best estimate of the cost to the reporting entity or entities will be made and included in the aggregate remuneration disclosed.

38. Requirements on the measurement of employee benefits are found in IPSAS 25, "Employee Benefits." When non-monetary remuneration that is able to be reliably measured has been included in the aggregate amount of remuneration of key management personnel disclosed for the period, disclosure would also be made in the notes to the financial statements of the basis of measurement of the non-monetary remuneration.

39. This Standard requires the disclosure of certain information about the terms and conditions of loans made to key management personnel and close members of the family of key management personnel, where these loans:

- (a) Are not widely available to persons outside the key management group; and
- (b) May be widely available outside the key management group but whose availability is not widely known to members of the public.

The disclosure of this information is required for accountability purposes. The exercise of judgment may be necessary in determining which loans should be disclosed to satisfy the requirements of this Standard. That judgment should be exercised after consideration of the relevant facts and in a manner consistent with the achievement of the objectives of financial reporting.

40. Paragraph 34(a) of this Standard requires disclosure of the aggregate remuneration of key management personnel. Key management personnel include directors or members of the governing body and members of the senior management group of the entity. Directors or members of the governing body of the entity may also receive remuneration or compensation from the entity for services provided in a capacity other than as director or member of the governing body of the entity or as an employee of the entity. Paragraph 34(b)(i) of this Standard requires the disclosure of the total amount of this other remuneration or compensation.

41. Close members of the family of key management personnel may influence, or be influenced by, key management personnel in their transactions with the reporting entity. Paragraph 34(b)(ii) of this Standard requires the disclosure of the total remuneration and compensation provided during the period to close members of the family of key management personnel.

FASB

FAS 57 Summary

This Statement establishes requirements for related party disclosures. The requirements of this Statement are generally consistent with those in Statement on Auditing Standards No. 6, *Related Party Transactions*, issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants.

INTRODUCTION

1. The FASB has been asked to provide guidance on disclosures of transactions between **related parties**. Examples of related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; (c) an enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's **management**; (d) an enterprise and its **principal owners**, management, or members of their **immediate families**; and (e) **affiliates**. Transactions between related parties commonly occur in the normal course of

business. Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and not record receipt of the services.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Disclosures

2. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:

- a. The nature of the relationship(s) involved
- b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement
- e. The information required by paragraph 49 of FASB Statement No. 109, *Accounting for Income Taxes*.

3. Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated.

4. If the reporting enterprise and one or more other enterprises are under common ownership or management **control** and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the enterprises.

Appendix B: GLOSSARY

24. For purposes of this Statement, certain terms are defined as follows:

- a. **Affiliate.** A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.

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b. **Control.** The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.

c. **Immediate family.** Family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.

d. **Management.** Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.

e. **Principal owners.** Owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.

f. **Related parties.** Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Related Party Issue Paper

At the April Board meeting, it was agreed that staff would develop a revised related party section of the draft standard and the Board would consider it in its entirety at the June meeting. The Board requested staff address issues because (1) the guidance might pull government contractors and others that may be economically dependent upon the government and (2) the “established by the federal government” criteria may be too broad. The Board suggested staff present background information, including FASB and GASB requirements and a summary of the issues at the June meeting. In resolving the related party issues, staff believes it is important to determine the objectives of related party disclosures at the government-wide and the component entity reporting levels. For purposes of comparison, staff noted the objectives – in brief – of the existing standards in other domains.

Background and Existing Guidance

As you may recall, FASAB completed the American Institute of Certified Public Accountants (AICPA) Omnibus project to adopt certain accounting and financial reporting guidance that resided in the AICPA statements on auditing standards (SAS). The Board decided to continue research on related parties as part of the Entity project and noted this in the basis for conclusion of SFFAS 39, *Subsequent Events: Codification of Accounting and Financial Reporting Standards Contained in the AICPA Statements on Auditing Standards*.

(Excerpt from basis for conclusion)

Related Parties

A8. AU Section 334, *Related Parties*, attributes the requirement for related party disclosures to the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) 850 (Statement of Financial Accounting Standards 57), *Related Party Disclosures*, and provides indicators of related party transactions. The FASAB determined that the related party guidance was not readily adaptable to the federal government and discussed the applicability of related FASAB projects and current federal financial reporting practices to the issue of related party transactions.

A9. The FASAB has an on-going Federal Entity project that is intended to define and characterize federal reporting entities and to establish criteria for including various organizational units in a reporting entity. Also, the project will involve research on the various types of relationships that the federal government has established to carry out its public policy functions. The FASAB believes that it would be premature to incorporate the related party guidance before it completes its Federal Entity project. Consequently, the FASAB decided to conduct research on related parties as part of the Federal Entity project and use the research results to develop related party guidance applicable to the federal government environment.

A10. In addition, the FASAB noted that federal agencies typically purchase goods and services from other federal agencies or organizational units within the same agency and the FASAB has provided guidance to assist in reporting this activity. The guidance includes, but is not limited to:

- a. SFFAS 4, *Managerial Cost Accounting Standards and Concepts*;
- b. SFFAS 5, *Accounting for Liabilities of the Federal Government*;
- c. SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*; and
- d. SFFAS 30, *Inter-Entity Cost Implementation: Amending SFFAS 4, Managerial Cost Accounting Standards and Concepts*.

A11. The FASAB expects that this statement will not alter current reporting practices. However, some are concerned that reporting practices may change if the auditing guidance changes before the Federal Entity project is completed. If so, the FASAB would issue a Technical Bulletin to assist the federal financial reporting community.

For example, SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, as amended, discusses inter-entity revenue and requires disclosure of the nature of intra-governmental exchange transactions in which an entity provides goods or services at a price less than full cost or does not charge a price at all.

In addition, Office of Management and Budget (OMB) Circular A-136 requires entities to report intragovernmental assets separately from those with non-federal entities and to disclose intragovernmental costs and revenue separately from costs and revenue with the public.

Beyond this, presently federal agencies are required to look to the GAAP hierarchy for guidance. Related party guidance most often cited has been the Financial Accounting Standards (FASB) 57, *Related Parties Disclosures* (FASB ASC 850).

Consideration of Other Standard Setters

Staff considered Related Party standards of other standard setters. The text of GASB, IPSASB, and FASB standards are included at Attachment 1 to this paper and selected excerpts presented in the body of the paper.

There was notable Board interest in how GASB approached this similar project -- addressing the issue of related party because requirements resided in AICPA's auditing literature. GASB concluded that the transition from the auditing literature to the accounting and financial reporting standards should be as undistruptive as possible; therefore, the existing AICPA guidance was adapted with minimal changes so that the guidance could be provided quickly and with minimal changes in practice.

The text box below includes the language with the changes included for the characteristics of the government.

GASB Related Party Transactions

4. State and local governments are required to disclose certain related party transactions. If the substance of a particular transaction is significantly different from its form because of the involvement of related parties, financial statements should recognize the substance of the transaction rather than merely its legal form.

5. Examples of transactions with related parties that have features that may indicate that governments should consider whether a *form-over-substance* condition exists include:

- a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction
- b. Selling real estate at a price that differs significantly from its appraised value
- c. Exchanging property for similar property in a nonmonetary transaction
- d. Making loans with no scheduled terms for when or how the loans will be repaid.

6. Determining the substance of a related party transaction may pose challenges not present in assessing transactions between unrelated parties. For example, a related party relationship may result in transactions that would not take place between unrelated parties or would be subject to different terms and conditions. In such cases, the substance of the related party transaction may differ from its legal form due to the related party relationship.

7. It may not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or what the terms and conditions would have been. Therefore, it may be difficult to determine whether a transaction was consummated on terms comparable to those that would be present in arm's-length transactions. Furthermore, governments frequently enter into transactions and engage in activities that are driven by societal needs and concern for the "public good." Therefore, it may not be appropriate to compare some governmental programs and arrangements to what might have occurred in an arm's-length transaction in the private sector or with unrelated parties.

The objectives of GASB's related party requirements appear to be:

1. ensure transactions are accounted for at amounts consistent with arms-length transactions (e.g., to avoid understating costs or asset values)
2. allow for the fact that governments often engage in transactions at non-arms-length amounts (e.g., non-exchange transactions) and provide that amounts for these transactions need not be adjusted

GASB's approach focuses on identifying transactions that are not arms-length and does not provide characteristics of related parties. Instead, when non-arms-length transactions are identified the question of relationships between the parties would be raised.

The IPSASB model also appeared relevant and staff found the following sections of particular interest because it was very specific to governmental departments and consideration of consolidated component entities.

IPSASB Related Party Transactions

18. Related party relationships exist throughout the public sector, because:

- (a) Administrative units are subject to the overall direction of the executive government and, ultimately, the Parliament or similar body of elected or appointed officials, and operate together to achieve the policies of the government;
- (b) Government departments and agencies frequently conduct activities necessary for the achievement of different components of their responsibilities and objectives through separate controlled entities, and through entities over which they have significant influence; and
- (c) Ministers or other elected or appointed members of the government and senior management group can exert significant influence over the operations of a department or agency.

14. Economic dependency, where one entity is dependent on another in that it relies on the latter for a significant volume of its funding or sale of its goods and services, would on its own be unlikely to lead to control or significant influence and is therefore unlikely to give rise to a related party relationship. As such, a single customer, supplier, franchisor, distributor, or general agent with whom a public sector entity transacts a significant volume of business will not be a related party merely by virtue of the resulting economic dependency. However, 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 economic dependence on a relationship. Where the reporting entity is economically dependent on another entity, the reporting entity is encouraged to disclose the existence of that dependency.

19. Disclosure of certain related party relationships and related party transactions and the relationship underlying those transactions is necessary for accountability purposes and enables users to better understand the financial statements of the reporting entity because:

- (a) Related party relationships can influence the way in which an entity operates with other entities in achieving its individual objectives, and the way in which it co-operates with other entities in achieving common or collective objectives;
 - (b) Related party relationships might expose an entity to risks or provide opportunities that would not have existed in the absence of the relationship; 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. This occurs frequently in government departments and agencies where goods and services are transferred between departments at less than full cost recovery as a part of normal operating procedures consistent with the achievement of the objectives of the reporting entity and the government. Governments and individual public sector entities are expected to use resources efficiently, effectively and in the manner
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intended, and to deal with public monies with the highest levels of integrity. The existence of related party relationships means that one party can control or significantly influence the activities of another party. This provides the opportunity for transactions to occur on a basis that may advantage one party inappropriately at the expense of another.

29. Public sector entities transact extensively with each other on a daily basis. These transactions may occur at cost, less than cost or free-of-charge. For example, a government department of administrative services may provide office accommodation free of charge to other departments, or a public sector entity may act as a purchasing agent for other public sector entities. In some models of government there may be the capacity for recovery of more than the full cost of service delivery. Departments are related parties because they are subject to common control and these transactions meet the definition of related party transactions. However, disclosure of information about transactions between these entities is not required where the transactions are consistent with normal operating relationships between the entities, and are undertaken on terms and conditions that are normal for such transactions in these circumstances. The exclusion of these related party transactions from the disclosure requirements of paragraph 27 reflects that public sector entities operate together to achieve common objectives, and acknowledges that different mechanisms may be adopted for the delivery of services by public sector entities in different jurisdictions. This Standard requires disclosures of related party transactions only when those transactions occur other than in accordance with the operating parameters established in that jurisdiction.

30. The information about related party transactions that would need to be disclosed to meet the objectives of general purpose financial reporting would normally include:

- (a) A description of the nature of the relationship with related parties involved in these transactions. For example, whether the relationship was one of a controlling entity, a controlled entity, an entity under common control, or key management personnel;
- (b) A description of the related party transactions within each broad class of transaction and an indication of the volume of the classes, either as a specific monetary amount or as a proportion of that class of transactions and/or balances;
- (c) A summary of the broad terms and conditions of transactions with related parties, including disclosure of how these terms and conditions differ from those normally associated with similar transactions with unrelated parties; and
- (d) Amounts or appropriate proportions of outstanding items

33. Disclosure of related party transactions between members of an economic entity is unnecessary in consolidated financial statements because consolidated financial statements present information about the controlling entity and controlled entities as a single reporting entity. Related party transactions that occur between entities within an economic entity are eliminated on consolidation in accordance with IPSAS 6. Transactions with associated entities accounted for under the equity method are not eliminated and therefore require separate disclosure as related party transactions.

However, staff notes the objective of IPSASB is broad with the Related Party definition addressing entities with significant influence which include associates, individuals, key management and close members of the family of key management personnel, etc. The definition is included below:

Related party parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions or if the related party entity and another entity are subject to common control.

Related parties include:

- (a) Entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the reporting entity;
- (b) Associates (see IPSAS 7, "Investments in Associates");
- (c) Individuals owning, directly or indirectly, an interest in the reporting entity that gives them significant influence over the entity, and close members of the family of any such individual;
- (d) Key management personnel, and close members of the family of key management personnel; and

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(e) Entities in which a substantial ownership interest is held, directly or indirectly, by any person described in (c) or (d), or over which such a person is able to exercise significant influence.

The IPSASB objectives include giving readers a better understanding of influences weighing on the reporting entity, risks and opportunities resulting from relationships, and reported results that may be over or understated as a result of other than arms-length transactions. These objectives are broader than the GASB objectives. Notable differences from the GASB standards include:

1. explicit requirements for information about key management remuneration including family members
2. broad disclosure of relationships where control exists even if there are no transactions
3. disclosure of information regarding transactions between related parties unless those transactions were:
 - a. no more or less advantageous than arms-length transactions
 - b. in the normal course of business and on normal terms between government departments (components of the same larger government)
4. economic dependency is addressed (see par. 14)

As noted above, related party guidance most often cited has been the Financial Accounting Standards (FASB) 57, *Related Parties Disclosures* (FASB ASC 850). However, staff notes the Board had decided this definition and approach – which is the AICPA approach - was not applicable in the current form to the federal environment. The definition provided is as follows:

FASB Related parties. Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Staff Analysis

The Board previously decided against adopting the AICPA auditing literature (i.e, the FASB standard) regarding related parties essentially “as is” because doing so may not have provided the federal financial reporting community with meaningful guidance because the AICPA language for related parties was not readily adaptable to the federal government environment. In addition, a definition of related parties for federal reporting entities was needed.

Based on a review of past minutes, Board members appear in agreement the focus of related parties should be on those entities outside the federal government and not on those within the federal government as existing guidance covers reporting of intra governmental transactions. This is also consistent with IPSASB’s approach which treats such relationships as a normal part of operations.

IPSASB also notes in its standard “Disclosure of related party transactions between members of an economic entity is unnecessary in consolidated financial statements because consolidated financial statements present information about the controlling entity and controlled entities as a single reporting entity. Related party transactions that occur between entities within an economic entity are eliminated on consolidation in accordance with IPSAS 6. Transactions with associated entities accounted for under the equity method are not eliminated and therefore require separate disclosure as related party transactions.”

When considering the main part of the related party definition—significant influence—this would be accomplished more so by certain federal entities that can significantly influence the operating policies of the transacting entities. For example, the Office of Management and Budget (OMB) provides policy and/or general management guidance to other federal entities, and the Office of Personnel Management (OPM) helps federal entities recruit nationwide and sets human resources management rules with the federal entities' involvement; administers the systems for setting federal compensation and benefits; manages federal employee health and life insurance programs; and operates the retirement program for federal employees. Thus, for the objective of better understanding the influences on entity operations—an understanding of certain relationships between federal entities may be helpful at the component level. (Note that component entities already explain – in MD&A and the statement of significant accounting policies – that they are components of a larger entity.)

Although related party relationships exist among the component entities of the federal government, component entities are subject to the overall direction and operate together to achieve the policies of the federal government and should not subject to the related party disclosure requirements. The government-wide reporting entity is presented on a consolidated basis and the transactions are eliminated to accurately reflect the distinctive nature of the federal government and provide information useful and understood to the citizens, their elected representatives, federal executives, and

program managers.¹ **Therefore, a component entity should be disclosed as a related party only when significant transactions are not arms-length transactions and disclosure is necessary to meet reporting objectives. However, the standards ought to be clear and address this point explicitly regarding component entities.**

In addition to intra-governmental relationships, staff considered relationships with outside entities. Knowledge of a private sector entity's relationships with related parties is often considered important. Related party disclosures are important in the private sector because related parties may enter into transactions that (1) unrelated parties would not or (2) are not at the same amounts as would occur between unrelated parties. The mere existence of non-arms-length business relationships may be sufficient to affect the transactions of the entity with other parties. However, when considering the universe of entities the federal government may have relationships with and who may exercise significant influence, there are infinite possibilities and countless types of entities and possible relationships that would have to be considered. For example:

1. collaboration between federal and state/local governments on programs (e.g., job training programs or Medicaid experimentation) and acceptance of a portion of the cost of programs (e.g, through unfunded mandates or direct cost-sharing agreements)
2. public-private partnerships to meet ongoing needs (e.g, military housing)
3. treaties that define common goals and means for joint action (e.g., NATO)
4. trade agreements that restrict options
5. stakeholders able to exert influence through elected officials

When considering the purpose or objective for disclosing related party information, one understands the importance in business and commerce where the disclosures may be to draw attention to the possibility that profit and loss may have been affected by the existence of the related party relationships and the underlying information (reliability, completeness, validity, comparability) to ensure it is arms-length. However, the objective of relationships that the federal government enters into and the resulting transactions and thereby the need or purposes for related party reporting, are far different. The federal government is not routinely or typically the party at an advantage in the relationship or transaction with others. Nor is the entire effect of the relationship or transaction easily expressed in financial terms. The purpose of the most of these relationships is for the good of the nation or to fulfill public policy goals and society needs.

Therefore, when one considers the federal government's role and its potential 'related party relationships' there would be an infinite number of related parties reported if parameters were not placed on what needs to be reported. Unless very specific parameters were developed to exclude classes or to identify a specific class for

¹ Par, 21 of SFFAC 1, *Objectives of Federal Financial Reporting* states that "federal financial reporting helps to fulfill the government's duty to manage programs economically, efficiently, and effectively and to be publicly accountable."

inclusion, it would be a very difficult task to identify all the related parties of the federal government. Further, some parties may not even be aware they are a related party.

Additionally, the cost of meeting this type of requirement and related disclosure would be high; the benefit of including an infinite amount of information would be lost because users would be overwhelmed. For example, staff believes there would be an infinite number of related parties reported including other countries, NATO, health care systems, treaties, United Nations, and an endless number of military and other contractors, etc. Staff does not believe the Board intended such a broad approach and has not developed an option that would encompass all the entities having relationships with and significant influence on the federal government.

Staff notes the Related Parties reported in previous CFR, such as the Federal Reserve and Amtrak may at a minimum be considered non-core in future years based on the new proposal.

The Board requested staff to consider whether the “established by the federal government” criteria may be too broad for the related party definition. Staff notes this was presented as part of the related party definition in the previous draft. The decision to put this in the related party definition was based on previous Board discussions that when a decision was made to remove it as an inclusion principle. At that time, the Board believed it would be best suited for consideration in related party. Therefore, staff believed it should be referenced in the related party definition to ensure entities that were established would be considered.

However, based on the discussion at the previous meeting, it appears the Board does not believe it is necessary to have the language in the definition. Several members noted it might bring in entities that the federal government established but has no ongoing relationship with or it will result in potentially disclosing a lot more entities. There appeared to be agreement among several members that the established by factor alone shouldn't be enough to require related party disclosures. Therefore, this is no longer included in the definition. Instead, staff proposes to include this as an indicator of significant influence or that an entity may be a related party. See the proposed language under the staff recommendation.

Staff Recommendation

Options:

Staff believes best approach is as follows:

1. Modify AICPA's language as necessary to fit the federal government environment. Explicitly state the objective of related party reporting is different for the federal government because the federal government normally engages in transactions that private enterprises would not and establishes long-standing relationships that influence

decisions. The necessary changes include identifying specific parameters and/or exclude classes from related party for the federal government due to its nature.

Alternatively, the Board may consider adopting:

2. a new definition for related party that is very narrow and specific for the federal environment.
3. AICPA's language as is. [Staff includes this but finds difficulty accepting because it would be difficult to apply as is. Also, staff believes this option is very broad and would lead to an infinite number of organizations reported.]

While staff believes the objective of related party reporting is different for the federal government, staff believes this can be accomplished using a related party definition based on significant influence, tailored for the federal environment, and focusing on meeting the objectives of revealing risks and influences that are outside normal operating conditions.

Staff recognizes 'related party' is a common or at least well-accepted term that has been used in the audit and professional community for quite some time. Therefore, staff believes it may be difficult to simply change the definition of a common term such as related party and have it accepted by others. Staff believes it is best to start from what is accepted then make the deviations that are necessary or state the limitations and exclusions as necessary.

Therefore, the staff recommendation is Option 1. Option 1 will provide users with information about the objective of related party reporting in the federal government while maintaining a definition that is based on significant influence. Staff proposes the following language for the ED:

Related Party Government-wide Reporting Entity

1. In addition to organizations for which Congress and the President are accountable, the federal government may be able to exercise significant influence over certain entities or be significantly influenced by certain entities. Where such influence is outside the scope of normal operations and/or federal government relationships, such parties are referred to as "related parties."
2. Certain information regarding related party relationships may enable users to better understand the financial statements of the government-wide 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.
3. Parties are considered to be **related parties** if the entities can be significantly influenced in making financial and operating decisions or if the federal government has an ownership interest but the entity was not included in the government-wide reporting entity.
 4. **Significant influence** is the power to participate in the financial and operating policy decisions of an entity, but it is not control over those policies.
 5. Indicators of significant influence may include the following: a large ownership interest² in an entity or if the entity was established³ by the federal government. In considering related parties, attention should be directed to the substance of the relationship and not merely the legal form.
 6. The objective of related party reporting in the federal government is to identify risks and influences that would not be expected in the normal operations of the federal government. The federal government enters into relationships for the good of the nation or to fulfill public policy goals and society needs. As a result, many complex relationships exist where significant influence is exerted. Judgment will be required to identify relationships that are not routine and may pose risks or introduce influences that warrant disclosure. In the context of this Statement, the following do not constitute significant influence and are not related parties:

² Large, but not a majority ownership interest. A majority ownership interest meets the inclusion principles set forth in the Standard.

³ Established by the federal government would exclude geographical political jurisdictions established by the federal government, (e.g., U.S. territories and insular areas, and the District of Columbia) because they have a different status under the U.S. Constitution. It also would not include those whose existence preceded federal recognition, such as many federally chartered corporations that received a congressional charter under Title 36 of the U.S. Code because many of these organizations were incorporated under state law before receiving their congressional charter (e.g., the Boy Scouts of America). For examples of different types of entities established by the federal government and how they were established, see GAO, Federally Created Entities: An Overview of Key Attributes, GAO-10-97 (Washington, D.C.: Oct. 2009).

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- 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
 - Entities that have no federal representation on their governing board
 - Key executives or other employees
 - Component entities of the federal government, see full discussion in par. 8
 - Foreign governments or international bodies
7. Although par. 6 permits exclusion of certain entities as related parties, other factors may create a need for related party disclosures. The use of judgment will be necessary in identifying those factors consistent with the objectives of related party disclosures.
8. Although related party relationships exist among the component entities of the federal government, component entities are subject to the overall direction and operate together to achieve the policies of the federal government and are not subject to the related party disclosure requirements. The government-wide reporting entity is presented on a consolidated basis and the transactions are eliminated to accurately reflect the distinctive nature of the federal government and provide information useful to and understood by the citizens, their elected representatives, federal executives, and program managers.⁴ However, a component entity should be disclosed as a related party if deemed material when significant transactions are not arms length transactions or when the preparer deems disclosure necessary.

Related Party Disclosures for Government-wide Reporting Entity

For any Related Party, the following should be disclosed:

1. 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

⁴ Par, 21 of SFFAC 1, *Objectives of Federal Financial Reporting* states that "federal financial reporting helps to fulfill the government's duty to manage programs economically, efficiently, and effectively and to be publicly accountable."

information also would include as appropriate: if the entity was being influenced and/or the percentage of ownership interest.

2. Other information that would provide an understanding of the potential financial reporting impact, including financial-related exposures to potential gain and risk of loss to the government-wide reporting entity resulting from the relationship.

QUESTIONS:

Does the Board agree with the Staff Recommendation for Related Party?

Does the Board agree with the proposed language for the ED?

Related Party for Component Reporting Entity (This is shaded to alert the Board because it relates to the Component Reporting Entity. Although all Board deliberations up to this point have been on the government-wide reporting entity, it was difficult to consider the Related Party issue without also considering the component reporting issue.)

Component Entity Reports are not a consolidation of a single economic reporting entity. Related party relationships exist among the component entities of the federal government because component entities are subject to the overall direction and operate together to achieve the policies of the federal government. Therefore the issue of whether other component relationships should be considered for related parties for disclosure must be assessed slightly different—from the component entity perspective. In addition, the component entity's relationship with outside entities is considered from the component entity perspective.

Although materiality may differ, staff considers if the same objectives and exclusions agreed upon for the government-wide perspective should apply at the component reporting entity? Is this a safe assumption or should this be explored further after the Board deliberates the government-wide?

Does the Board wish to make these decisions before the decisions regarding the component reporting entity standard are finalized?

Component Reporting Entity--

9. In addition to organizations for which the [component Department or equivalent] are accountable, the component reporting entity may be able to exercise significant influence over certain entities or be significantly influenced by certain entities. Where such influence is outside the scope of normal operations and/or component reporting entity relationships, such parties are referred to as “related parties.”
10. Certain information regarding related party relationships may enable users to better understand the financial statements of the government-wide reporting entity because:
 - (a) Related party relationships might expose the component reporting entity 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 component reporting entity 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.
11. Parties are considered to be **related parties** if the entities can be significantly influenced in making financial and operating decisions or if the component reporting entity has an ownership interest but the entity was not included in the component reporting entity.
12. **Significant influence** is the power to participate in the financial and operating policy decisions of an entity, but it is not control over those policies.

QUESTION: What are the Board’s tentative thoughts for Related Party Reporting at the Component Reporting Entity level? Should the objectives, definition and such be the same as the government-wide?
