

# Issues Paper

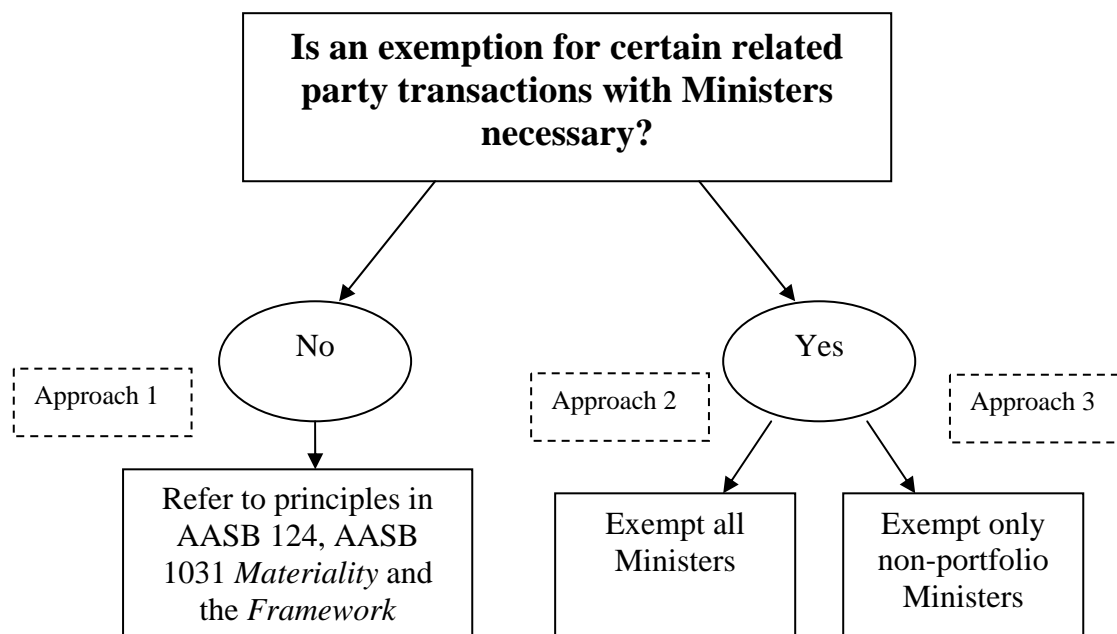
## Related Party Disclosures in the Not-for-Profit Public Sector

January 2011

1. At its September 2010 meeting, the Board discussed whether to provide an FRSB-equivalent exemption for not-for-profit (NFP) public sector entities in Australia, i.e. an exemption for transactions of non-portfolio Ministers (subject to disclosures concerning ‘significant’ transactions). However, the Board decided that any exemption should extend to all Ministers (i.e. portfolio and non-portfolio Ministers). The Board requested further research into whether the principles in AASB 124 *Related Party Disclosures* would result in the non-disclosure of routine related party transactions of Ministers. The Board requested that staff investigate the following options:
  - (a) further clarification of the principles in AASB 124 with regard to NFP public sector entities; or
  - (b) the possibility of exempting entities from disclosing certain routine related party transactions with all Ministers.

This Issues Paper also addresses the exemption for Ministers in the context of local government – see paragraphs 22-26.

2. Staff have created the following diagram to illustrate the issue:



3. The central theme of this Issues Paper is the consideration of Approaches 1 and 2. At the September 2010 AASB meeting, the Board considered Approach 3, which is essentially the FRSB approach (for completeness, possible improvements to Approach 3 are covered in paragraphs 16-21 of this paper). The FRSB inserted paragraph NZ 25.1

in NZ IAS 24, which exempts a reporting entity from disclosing related party transactions according to paragraph 18 of NZ IAS 24 for Ministers of the Crown who do not have portfolio responsibility for the reporting entity. Paragraph NZ 26.1 requires limited disclosures concerning ‘significant’ transactions that are exempt under paragraph NZ 25.1. Paragraphs NZ 25.1 and NZ 26.1 and their related paragraphs (and other paragraphs that are of interest throughout this Issues Paper) are quoted in the Appendix to this Issues Paper.

4. Broadly, the types of transactions of Ministers and close members of their family that might be exempted from explicit disclosure are:
  - (a) legislative transactions – these transactions arise due to legislative requirement, such as a Minister or family member being required by law to pay taxes to a tax office;
  - (b) personal transactions – these transactions arise from the routine and domestic needs of the Minister or family member. For example, a related party transaction may arise with Australia Post when a Minister (whether portfolio or not) mails an item. Likewise, a Commonwealth Minister may take up health insurance with Medibank Private Limited which results in a related party transaction; and
  - (c) work expenses/transactions – these are transactions that are in relation to the Minister’s or family member’s work duties. For example, a Minister may use a government rail network as transport for a work trip. However, exemption from disclosure may not be desirable for a family member paid for consulting services, for example.

## **Approach 1: Rely on Principles in Accounting Standards**

### **AASB 124**

5. The revised definition of ‘related party’ in paragraph 9 of AASB 124 (reproduced in the Appendix to this paper) separately considers persons related to the reporting entity and entities related to the reporting entity. Paragraph 18 imposes certain disclosure requirements in regard to related party transactions. The paragraph 25 relief applies only to government-related **entities** that are related to the reporting entity (as opposed to persons e.g. Ministers).
6. However, paragraph 18 in AASB 124 may automatically exempt an entity from disclosing Minister-related transactions detailed in paragraph 5 of this Issues Paper to an appropriate extent. Paragraph 18 requires an entity to “disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements”. If a NFP public sector entity considers that disclosing a Minister’s transaction with the entity is not necessary for users to understand the potential effect of the Ministerial relationship on its financial statements, it can choose not to disclose it. For example, if Entity A is a Department of Transport (which is a NFP public sector entity) in Jurisdiction A and a Minister has used public transport during the financial year, Entity A need not disclose this transaction in its

financial statements if it concludes that users would not require the disclosure in order to understand the effect of the Ministerial relationship.

### **Framework for the Preparation and Presentation of Financial Statements**

7. Paragraphs 1 and 5-8 of AASB 124 indicate that the presence of related parties may affect the profit or loss and the financial position of an entity. Although NFP public sector entities differ from for-profit entities in that their primary objective generally is to provide goods or services for community or social benefit, the ability of such entities to achieve their non-financial objectives may depend upon their financial performance and financial position. Nevertheless, paragraph 44 of the AASB *Framework* notes that the “benefits derived from information should exceed the cost of providing it”. It is arguable that the cost of disclosing most Ministerial related party transactions in the financial statements do not outweigh the benefits of disclosing them.

### **Materiality**

8. Because most Minister-related transactions would be of a domestic and trivial nature, they are likely to be immaterial. Paragraph Aus1.8 of AASB 124 states that the requirements of paragraphs 1-28 apply where information resulting from their application is material in accordance with AASB 1031 *Materiality*.
9. Under AASB 1031, whether information in financial statements is material depends on the size and nature of the information. However, paragraph 12(b)(i) explicitly states that transactions between “an entity and parties who have a fiduciary responsibility in relation to that entity, such as those transactions outlined in AASB 124” may be deemed material, regardless of size.
10. Of lesser relevance for the scope of this paper but still noteworthy, paragraph 14 of AASB 1031 refers NFP entities to paragraphs 17-19 (instead of paragraph 13(b)) for determining whether the amount of an item or an aggregate of items in the statement of comprehensive income is material. For example, paragraph 18 would suggest that a transaction with a Minister is material if it was entered into with the intention of modifying significantly the profit or loss of the entity, e.g. turning a loss into a profit.
11. With regard to Minister-related transactions, an entity will have to decide which (if any) should be disclosed in an entity’s financial statements on materiality grounds. However, the application of the materiality criterion can be difficult in practice. An FASB *Disclosure Framework* project is researching whether entities practice “defensive” reporting based on the view that the risk of a material omission far outweighs the “do no harm” compliance attitude of disclosing information (Minister-related transactions in this context) even though it is not critical, helpful, or otherwise relevant in an entity’s particular circumstances.

## **Approach 2: Exempt Entities from Disclosing Certain Related Party Transactions with All Ministers**

### **Types of transactions to be exempted**

12. If the Board were to adopt Approach 2, it has suggested that only routine related party transactions involving Ministers might be exempted from explicit disclosure (see paragraph 1 of this Issues Paper). Identifying the subset of transactions that should be exempted is the issue here.
13. One way might be to insert an Aus paragraph into AASB 124 stating that only non-routine Minister-related transactions are required to be disclosed and utilising paragraph 21 of AASB 124 to illustrate examples of non-routine transactions. However, staff are of the view that the examples listed in paragraph 21 could be routine in nature. For example, a Minister buying stamps from a government-controlled post-office would be a routine sale of goods covered by paragraph 21(a). Staff consider that it would be very difficult to develop a list of either routine or non-routine types of transactions for inclusion in the Standard.
14. Another way would be to insert an Aus paragraph based on paragraph Aus29.9.3 in AASB 124. Paragraph Aus29.9.3 (quoted below) applies to disclosing entities and provides relief for transactions between the disclosing entity and KMP (etc) when certain conditions are met. The conditions in paragraphs (a), (b) and (c) appear to be a suitable basis for determining Minister-related transactions that need not be disclosed.

Transactions with and amounts receivable from or payable to a key management person, a close member of the family of that person, or an entity over which either of these persons have, directly or indirectly, control, joint control or significant influence, are excluded from the requirements of paragraphs Aus29.9 to Aus29.9.2 when:

- (a) they occur within a normal employee, customer or supplier relationship on terms and conditions no more favourable than those that it is reasonable to expect the entity would have adopted if dealing at arm's length with an unrelated person;
  - (b) information about them does not have the potential to affect adversely decisions about the allocation of scarce resources made by users of the financial statements, or the discharge of accountability by the key management person; and
  - (c) they are trivial or domestic in nature.
15. An issue that would arise with any disclosure exemption paragraph is whether summary disclosure is needed for the exempted transactions. Staff consider that there are three alternatives:
    - (a) inserting a paragraph based on paragraph 26 of AASB 124 and paragraph NZ 26.1, which would require sufficient disclosure of individually or collectively significant transactions;
    - (b) requiring a general description of the exempted transactions; or
    - (c) no disclosure being required at all.

Staff consider that transactions exempted from disclosure under the criteria in paragraph Aus29.9.3 should not be required to be disclosed in summary form or by general description.

### **Approach 3: Possible Areas of Improvement to the FRSB's Exemption**

16. As noted in paragraph 1 above, the Board currently supports extending any exemption to all Ministers, rather than adopting the FRSB's exemption. However, if the Board decides in further stages in this project to revert to the FRSB exemption, staff have identified the following areas of potential improvements.

#### **Implication that portfolio ministers are KMP**

17. The FRSB's exemption assumes that portfolio Ministers are KMPs of all the NFP entities that are under his/her portfolio (see paragraph NZBC5). This may be appropriate for departments through which Ministers administer their portfolio(s) but inappropriate for other agencies that are consolidated into the financial reports of their respective portfolio department or directly into whole of government financial reports.
18. For example, assume a government has only one portfolio, with Minister A in charge of their Portfolio A. Minister A administers his/her portfolio through Department A and Department A has two agencies reporting to it – Agencies B and C. Department A and Agencies B and C are reporting entities and therefore need to prepare general purpose financial statements. Staff are of the view that it is more likely that Minister A would be a KMP to Department A rather than a KMP to Agencies B and C.
19. Under the FRSB's exemption, all three entities would need to disclose any (portfolio) Minister-related transactions in their financial statements. This may result in unnecessary Minister-related disclosures from Agencies B and C. However, that outcome does not require Minister A to be regarded as a KMP of Agencies B and C. Minister A would be a related party of Agencies B and C merely by being a KMP of Department A (i.e. a KMP of a parent – paragraph 9(a)(iii)). Therefore, it would seem more appropriate not to assume that a portfolio Minister is a KMP of all the entities within the portfolio.

#### **Routine transactions of portfolio Ministers**

20. Paragraph NZBC4 notes that the purpose of the FRSB exemption is to exempt entities from disclosing routine transactions with Ministers. However, paragraph NZ 25.1 only exempts entities from the disclosure requirements of paragraph 18 in relation to related party transactions with non-portfolio Ministers. The FRSB exemption does not exempt routine related party transactions with portfolio Ministers. The application of materiality would be required to scope out most of these transactions.

#### **Close family members as KMP of the parent entity**

21. Paragraph NZ 25.1 exempts disclosures concerning close family members of a Minister who are themselves KMP of "the parent of the reporting entity". The close family members could not be KMP of the government. However, they could be KMP of an intermediate parent entity, and the NZ paragraphs appear to extend the exemption to

them. No such exemption seems warranted though – close family members who are KMPs themselves are in the same position relative to an entity as any KMP, and their transactions should be subject to the same related party disclosure requirements.

### **Staff recommendations**

Staff are of the view that the principles in various Australian Accounting Standards could achieve the Board's objective and result in the non-disclosure of routine related party transactions involving all Ministers. However, in practice this would depend on an entity's application of the materiality and "necessary for users to understand the potential effect of the relationship" criteria.

Staff believe that it would be beneficial to explicitly exclude NFP public sector entities from disclosing routine Minister-related transactions and thus remove the practical difficulty.

With regard to the question of determining the types of transactions to be exempted, staff recommend inserting an Aus paragraph that is based on paragraph Aus29.9.3 of AASB 124, without any summarised disclosure being required.

Therefore, on balance, staff recommend that the Board adopt Approach 2.

**Does the Board agree in principle with the recommendations of the staff?**

## **Local Governments**

22. The focus of previous AASB discussions on this topic has been mostly on the federal and state/territory governments rather than local governments. Local governments receive part of their income as grants from state executive government and raise their own revenue through local taxes such as rates. The main responsibilities of local councils include the construction and maintenance of local roads, water and sewerage services, building standards, sporting facilities, and health standards in shops. The states and territories each have local governments within their borders. Each state or territory government defines the powers of the local governments within its borders, and decides the geographical areas for which local governments are responsible. Therefore, local governments are accountable to the Ministers of their respective states and territories.
23. Local governments are managed directly by the elected councillors and staff. It is most likely that the councillors and senior staff (such as the Chief Executive Officer and Chief Financial Officer) would be identified as KMP of the local government. This issue appears to be analogous to the issue of any federal/state/territory public sector entity determining its KMP. The Board has previously decided that no amendment to the definition of KMP is necessary, and the circumstances of local government do not suggest that amendment would be required.
24. Furthermore, local governments may be subject to the direction of the relevant state or territory government. For example, a state government Minister may be able to replace

an elected council with an administrator due to the council's misconduct. Therefore, a state or territory government Minister might be considered to be a KMP of a local government in the same way that a federal/state/territory Minister might be considered to be a KMP of public sector entities within the whole of government.

25. Based on this view, the question of disclosure exemptions in the context of local government is analogous to that for federal/state/territory governments, which has been addressed in the previous sections of this Issues Paper: a federal/state/territory Minister is in the same position relative to a local government as to public sector entities within the federal/state/territory whole of government. Under this view, the same approach to Ministerial disclosure exemption should be adopted in relation to local governments.
26. An alternative view is that councillors of a local government should also be regarded as in a similar position to Ministers – KMP of the parent entity (the council), but sufficiently remote from other entities within the local government group that there should also be disclosure exemptions in relation to their transactions with those other entities. However, it is doubtful that councillors are in substance as remote from subsidiary entities as Ministers. This alternative view would also call into question the disclosure of any related party transactions in relation to KMP of a parent of the reporting entity who are not otherwise related to the reporting entity. Such an exemption would be very broad.

#### **Staff recommendations**

Staff recommend that Approach 2 also be adopted for Ministers in relation to local governments, that is, that local governments (as NFP public sector entities) should not be required to disclose routine Minister-related transactions.

Staff do not propose any explicit exemption in relation to councillors of local governments.

**Does the Board agree with the recommendations of the staff?**

## APPENDIX - Extracts from Pronouncements

### NZ IAS 24 *Related Party Disclosures*

#### Public Benefit Entities

NZ 25.1 A reporting entity is exempt from the disclosure requirements of paragraph 18 in relation to related party transactions and outstanding balances, including commitments, with any Minister of the Crown or close member of that Minister's family who meets the definition of a related party in accordance with paragraph 9(a)(iii) because they are a member of the key management personnel of the parent of the reporting entity, except for any Minister of the Crown (or close member of that Minister's family) with portfolio responsibility for the reporting entity during the time they had portfolio responsibility.

NZ 26.1 If a reporting entity applies the exemption in paragraph NZ 25.1, it shall disclose the following about the transactions and related outstanding balances referred to in paragraph NZ 25.1 in sufficient detail to enable users of the entity's financial statements to understand the exempted related party transactions:

- (i) the nature and amount of each individually significant transaction with reference to the factors outlined in paragraph 27; and
- (ii) for other transactions that are collectively, but not individually significant, a qualitative or quantitative indication of their extent. Types of transactions include those listed in paragraph 21.

For completeness, paragraphs 21 and 27 respectively read:

21 The following are examples of transactions that are disclosed if they are with a related party:

- (a) purchases or sales of goods (finished or unfinished);
- (b) purchases or sales of property and other assets;
- (c) rendering or receiving of services;
- (d) leases;
- (e) transfers of research and development;
- (f) transfers under licence agreements;
- (g) transfers under finance arrangements (including loans and equity contributions in cash or in kind);
- (h) provision of guarantees or collateral;
- (i) commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised); and
- (j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party.

27 In using its judgement to determine the level of detail to be disclosed in accordance with the requirements in paragraph 26(b), the reporting entity shall consider the closeness of the related party relationship and other factors relevant in establishing the level of significance of the transaction such as whether it is:

- (a) significant in terms of size;
- (b) carried out on non-market terms;
- (c) outside normal day-to-day business operations, such as the purchase and sale of businesses;
- (d) disclosed to regulatory or supervisory authorities;
- (e) reported to senior management;
- (f) subject to shareholder approval.

The Basis for Conclusions notes the following in respect of paragraphs NZ 25.1 and NZ 26.1:

NZBC4 ... the FRSB noted that in the IASB's rewording and clarification of the related party definition, Ministers of the Crown determined to be key management personnel of the Government (the parent), are explicitly determined to be related parties, of each entity within the Government Reporting Entity. Without an exemption, this clarification could result in voluminous disclosures within individual reporting entity financial statements about Ministers' routine transactions with entities within the Government Reporting Entity.

NZBC5 Accordingly, the FRSB proposed the insertion of New Zealand specific paragraph NZ 25.1, providing an exemption for any Minister of the Crown (or close member of that Minister's family) who meets the definition of a related party because the Minister or close family member is a member of the key management personnel of the parent of the reporting entity in accordance with paragraph 9(a)(iii) of NZ IAS 24. However, that exemption does not apply to Ministers who have portfolio responsibility for the reporting entity (are members of the key management personnel of the reporting entity itself). The FRSB noted that judgment will be required to determine whether a Minister of the Crown is a member of the key management personnel of the reporting entity. Paragraph NZ 26.1 clarifies that the application of NZ 25.1 does not exempt disclosures detailing the nature and amount of individually significant transactions, nor does it exempt a qualitative and quantitative indication of the extent of collective transactions. Paragraph NZ 26.1 also clarifies that reference should be made to the factors detailed in paragraph 27, to assist with making the required disclosures.

## AASB 124 *Related Party Disclosures*

9 The following terms are used in this Standard with the meanings specified:

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the ‘reporting entity’).

- (a) A person or a close member of that person’s family is related to a reporting entity if that person:
  - (i) has control or joint control over the reporting entity;
  - (ii) has significant influence over the reporting entity; or
  - (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- (b) An entity is related to a reporting entity if any of the following conditions applies:
  - (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
  - (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  - (iii) Both entities are joint ventures of the same third party.
  - (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  - (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
  - (vi) The entity is controlled or jointly controlled by a person identified in (a).
  - (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

*Close members of the family of a person* are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

- (a) that person’s children and spouse or domestic partner;
- (b) children of that person’s spouse or domestic partner; and
- (c) dependants of that person or that person’s spouse or domestic partner.

*Key management personnel* are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

18 If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to those in paragraph 17. At a minimum, disclosures shall include:

- (a) the amount of the transactions;
- (b) the amount of outstanding balances, including commitments, and:

- (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
    - (ii) details of any guarantees given or received;
  - (c) provisions for doubtful debts related to the amount of outstanding balances; and
  - (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.
- 21 The following are examples of transactions that are disclosed if they are with a related party:
- (a) purchases or sales of goods (finished or unfinished);
  - (b) purchases or sales of property and other assets;
  - (c) rendering or receiving of services;
  - (d) leases;
  - (e) transfers of research and development;
  - (f) transfers under licence agreements;
  - (g) transfers under finance arrangements (including loans and equity contributions in cash or in kind);
  - (h) provision of guarantees or collateral;
  - (i) commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised); and
  - (j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party.
- 25 A reporting entity is exempt from the disclosure requirements of paragraph 18 in relation to related party transactions and outstanding balances, including commitments, with:
- (a) a government that has control, joint control or significant influence over the reporting entity; and
  - (b) another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.
- 26 If a reporting entity applies the exemption in paragraph 25, it shall disclose the following about the transactions and related outstanding balances referred to in paragraph 25:
- (a) the name of the government and the nature of its relationship with the reporting entity (ie control, joint control or significant influence);
  - (b) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:
    - (i) the nature and amount of each individually significant transaction; and
    - (ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent. Types of transactions include those listed in paragraph 21.

## AASB 1031 *Materiality*

- 9 The standards specified in other Australian Accounting Standards apply to the financial statements when information resulting from their application is material. Information is material if its omission, misstatement or non-disclosure has the potential, individually or collectively, to:
- (a) influence the economic decisions of users taken on the basis of the financial statements; or
  - (b) affect the discharge of accountability by the management or governing body of the entity.
- 12 In deciding whether an item or an aggregate of items is material, the size and nature of the omission or misstatement of the items usually need to be evaluated together. In particular circumstances, either the nature or the amount of an item or an aggregate of items could be the determining factor. For example:
- (a) in the context of error corrections or adjustments for events occurring after the reporting period, materiality based on amount alone is sufficient to require a correction or an adjustment to be made; and
  - (b) it may be necessary to treat as material an item or an aggregate of items which would not be judged material on the basis of the amount involved, because of their nature. This may apply when:
    - (i) transactions occur between an entity and parties who have a fiduciary responsibility in relation to that entity, such as those transactions outlined in AASB 124 *Related Party Disclosures* and AASB 1046 *Director and Executive Disclosures by Disclosing Entities*; or
    - (ii) restrictions on the powers and operations of the entity affect the risks and uncertainties relating to an item, for example, legal restrictions imposed by governments on assets held in foreign countries; or
    - (iii) an entity expands its operations into a new segment which affects the assessment of the risks and opportunities facing the entity; or
    - (iv) a change in circumstances puts the entity in danger of breaching a financial covenant.
- 14 As not-for-profit entities are primarily concerned with the achievement of objectives other than the generation of profit, such as service delivery, it may not be appropriate to assess materiality for statement of comprehensive income items by reference to profit or loss or average profit or loss in the manner outlined in paragraph 13(b). In these cases, the guidance set out in paragraphs 17-19 is more appropriate to consider. A not-for-profit entity is an entity whose principal objective is not the generation of profit. A not-for-profit entity can be a single entity or a group of entities comprising the parent and each of the entities that it controls.
- 17 In practice materiality judgements are typically made on the basis described in paragraph 13. However, further indications of materiality may be evident from making assessments of the items in an absolute and a relative context. This may necessitate disclosure of information in the financial statements about items which are not considered material in amount in accordance with paragraph 13.
- 18 In absolute terms, consideration is given to the financial statements as a whole. In particular, consideration is given to factors which may indicate deviations from normal activities such as the reversal of a trend, turning a profit into a loss or creating or

eliminating the margin of solvency in a statement of financial position. For example, when the entity's financial position has deteriorated, and the entity has revalued items of property, plant or equipment upwards, information regarding the revaluation of those assets would be likely to be material, and thus the accounting and disclosure requirements specified in AASB 116 *Property, Plant and Equipment* would apply, even though the revaluation amount may not be material by comparison with the recorded amount of equity.

- 19 In relative terms, items are compared to any directly related items. The amount of an item may not be material when judged on the basis described in paragraph 13, but its size in relation to a related item may indicate that information about it is material. For example, the amount of interest revenue would be compared with the amount of the relevant loans. Such a comparison may indicate that information about the interest is material because its amount is much lower (or higher) than expected, having regard to the loan balance and applicable interest rates.