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Advisor alert—Sections PS 2200 *Related Party Disclosures & PS 3420 Inter-entity Transactions*

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Overview

In March 2015, the Canadian Public Sector Accounting Standards Board (PSAB or the Board) issued two new accounting standards dealing with related party disclosures and the recognition and measurement of related party transactions between certain related parties. The standards apply to all governments and government organizations applying the *CICA Public Sector Accounting Handbook*. The new standards are effective for fiscal years beginning on or after April 1, 2017. Earlier adoption is permitted.

Our view

The proposals will have a greater impact on lower-level government organizations that issue individual entity financial statements than on higher levels of government that issue consolidated financial statements.

Summary of the new standards

What is a related party and a related party transaction?

From the reporting public sector entity's perspective, related parties typically include

- entities that control it, share control of it or it controls;
- entities that are subject to common control;
- entities that it shares control of with other commonly controlled entities;
- entities that are subject to shared control by other commonly controlled entities;
- entities that it shares control of with other entities;
- entities that are subject to shared control by other commonly controlled entities and other entities;

- individuals that are members of key management personnel and their close family members (e.g., spouses and dependents); and
- entities controlled by, or under shared control of, a member of key management personnel or a close family member of that individual.

The determination of whether an individual is a member of key management personnel is a matter of judgment. Key management personnel could include directors or members of the governing body of the entity who have the authority and responsibility for planning, directing and controlling the activities of the entity and senior management who have the day-to-day responsibility for managing the entity's activities and operations and implementing the governing body's initiatives. When two entities have a member of key management personnel in common, the public sector entity will need to consider the level of influence the individual has over the decision-making process of both entities and the likelihood that the individual is able to affect the policies of both entities in their mutual dealings to determine whether there is a related party relationship. A public sector entity may be related to a close family member of key management if the close family member holds an ownership interest that allows the individual to govern or share the power to determine the ongoing financial and operating decisions of that entity.

A related party transaction is either a transfer of economic resources or obligations between related parties, or the provision of services by one party to a related party. For example, the transfer of a building between two government not-for-profit organizations that are controlled by a municipality is a related party transaction.

Disclosures

The disclosure requirements for related party transactions, which are located in Section 2200 *Related Party Disclosures*, require disclosure of sufficient information about the terms and conditions of related party transactions and related party relationships to enable users to assess the effect that they have had, or, if not recognized, may have had, on a public sector entity's reported financial position and changes in it. The disclosure requirements include

- the nature of the relationship between the related parties;
- the types of related party transactions that have been recognized;
- the basis of measurement used;
- the amount of and terms and conditions for outstanding balances;
- contractual obligations and contingencies involving related parties; and
- the nature of related party transactions that have not been given accounting recognition.

For related party transactions that have not been given accounting recognition, an entity must provide either qualitative or quantitative information on the extent of the transactions. Public sector entities have to use judgment to determine the amount of detail to be disclosed. Some of the factors to consider include the

significance of the transactions in terms of size and whether the transactions were carried out on non-market terms.

Inter-entity transactions

Section PS 3420 *Inter-entity transactions* provides the recognition and measurement requirements for transactions between public sector entities that comprise a government's reporting entity from both a provider and recipient perspective. In other words, it prescribes the recognition and measurement criteria for related party transactions between entities that make up a government reporting entity. For example, a Province and all the entities that it controls and shares control of would make up the government reporting entity; thus, a hospital that is controlled by the Province would be required to recognize and measure its transactions with other entities that make up the government reporting entity in accordance with the Section.

Inter-entity transactions may involve the transfer of assets and liabilities, cost allocations and recoveries, or unallocated costs. Cost allocation and recovery is the allocation of costs of providing goods or services to another entity and the recovery of the costs incurred from that entity; these recoveries may be the result of a direct exchange of consideration or an accounting entry. Unallocated costs represent the cost of resources recorded by the providing entity in its operating activities that are incurred on behalf of a recipient entity; in other words, the provider incurs and records the expenditures in its own records and does not recover any of the costs from the recipient of those goods and services. For example, a provider may be responsible for the debt management, pension administration, procurement or other shared services that apply across all government entities, but it may fund those costs through appropriations or other revenue sources and not allocate the costs to the recipients.

Recognition

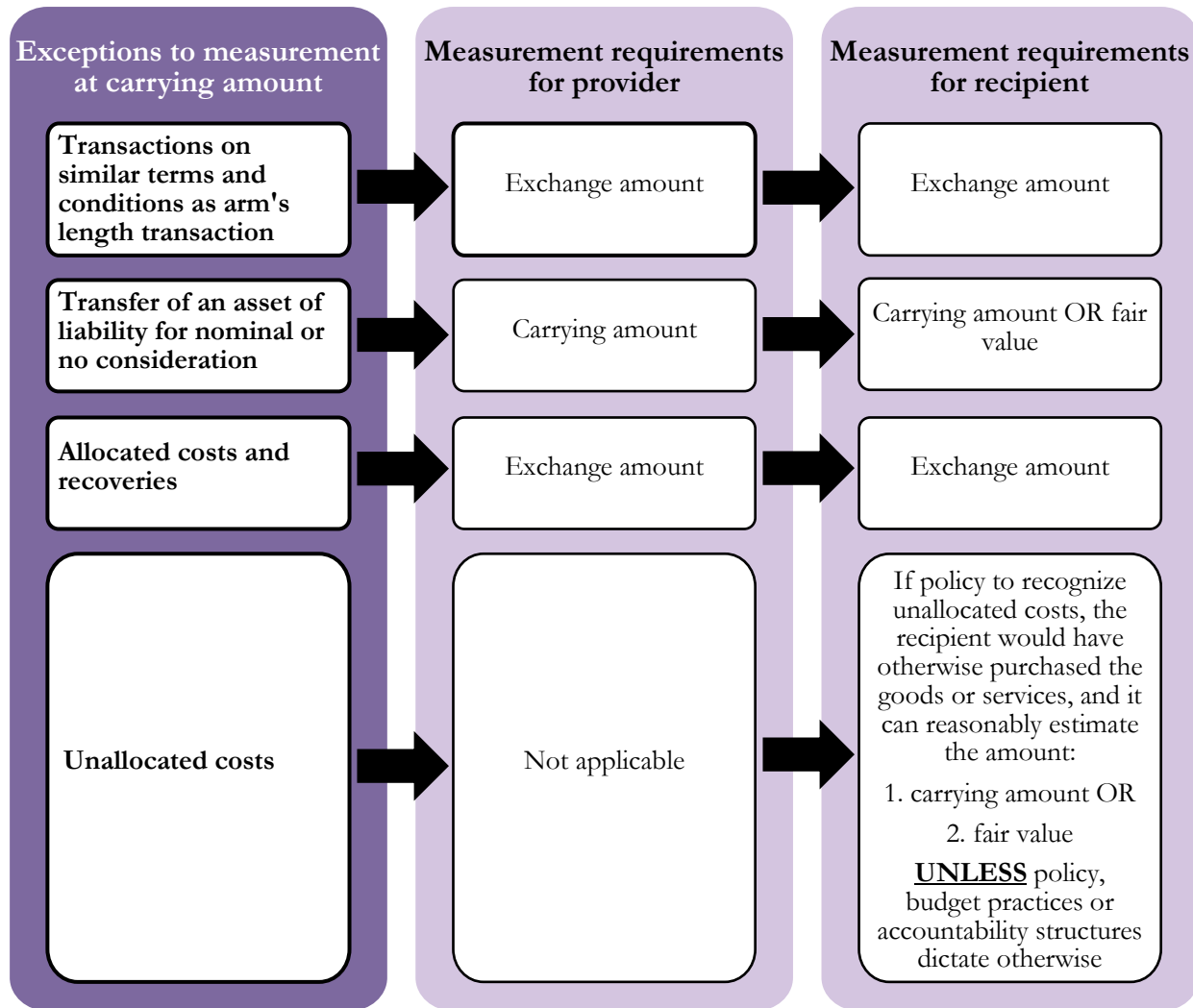
The recognition requirements for inter-entity transactions depend on the type of transaction:

- **Transfers of assets and liabilities**—These transactions are recognized by both the provider and the recipient.
- **Cost allocation and recovery**—When there is a policy of allocating and recovering costs, the provider reports all recoveries (i.e., revenues) and expenses on a gross basis and the recipient reports all expenses on a gross basis. For example, if School Board X subleases a location to School Board Y, it would report the recoveries received from School Board Y as revenue and present the operating lease expense separately; it would not net the recovery against the expense. School Board Y would record the sublease amount as an expense.
- **Unallocated costs**—Where there is no policy for allocating and recovering costs, the recipient may choose to recognize the costs incurred by a provider of goods or services but not recovered from the recipient, only if it would have

otherwise purchased the goods or services and a reasonable estimate of the amount involved can be made. If the recipient recognizes these amounts, it must report them as revenues and expenses.

Measurement

At the transaction date, an inter-entity transaction must be measured at its carrying amount with the following exceptions:



Carrying amount is the amount of an item transferred, or cost of services provided, as recorded in the accounts of the provider, after adjustments, such as amortization, impairment or changes in the fair value, if any. For example, the carrying amount of a tangible capital asset is the net of its cost, accumulated amortization and any impairment. For other assets, the carrying amount may be the net of cost and valuation allowances or fair value, as appropriate. Exchange amount is the amount of the consideration given for the item transferred or service provided as established and agreed to by the related parties. Lastly, fair value is the amount of

consideration that would be agreed upon in an arm's length transaction between knowledgeable and willing parties who are under no compulsion to act.

When there is a difference between the exchange amount and the carrying amount of a transferred or exchanged asset or liability, a gain or loss is reported in the statement of operations.

Recognition and measurement of transaction with other related parties

Section PS 3240 does not prescribe the recognition and measurement requirements for transactions between related parties that are not part of the reporting entity, such as those with key management personnel. Using the hierarchy in Section 1150 *Generally Accepted Accounting Principles* (GAAP), public sector entities can look to Section 3240 when choosing an accounting policy for these types of transactions; however, entities are not required to apply the guidance. Regardless of whether a public sector entity uses the GAAP hierarchy in Section PS 1150 to look elsewhere in arriving at an accounting policy, it must have a recognition and measurement policy for transactions between these related parties that is consistent with the basic principles of recognition and measurement in Section 1000 *Financial Statement Concepts*.

Transitional provisions

Sections PS 2200 and PS 3420 must be adopted for fiscal years beginning on or after April 1, 2017. Earlier adoption is permitted. For Section PS 2200, the standard is adopted prospectively, while for PS 3420 *Inter-entity transactions* the entity has the choice of retroactive or prospective application.

Conclusion

The addition of Sections PS 2200 and PS 3420 to the Public Sector Accounting Handbook means that public sector entities will need to develop processes to identify related parties and track related party transactions to ensure they are recognized, measured and disclosed properly.

Reach out to your Grant Thornton LLP advisor if you have any questions about these new standards.

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