



Project	Consolidation
Topic	Related parties

Introduction

1. Subtopic 810-10 of the FASB's Accounting Standards Codification as amended by Statement No.167 and ED10 *Consolidated Financial Statements* both include guidance regarding related parties. Although the list of parties that are considered to be related parties are similar in the two documents, ED10 notes that those parties *often* act for the reporting entity, while Subtopic 810-10 as amended by Statement No.167 assumes that those parties *always* act for the reporting entity. In addition, Subtopic 810-10 as amended by Statement No.167 includes guidance to help identify whether the reporting entity or the related party should consolidate the other entity.
2. This paper discusses what guidance should be included in future publications on consolidation regarding related parties.

Subtopic 810-10 as amended by Statement No.167 and ED10

3. Subtopic 810-10, as amended by Statement 167, includes the following guidance regarding related parties:

The Effect of Related Parties

810-10-25-42 For purposes of determining whether it is the primary beneficiary of a VIE, a reporting entity with a variable interest shall treat variable interests in that same VIE held by its related parties as its own interests.

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810-10-25-43 For purposes of the Variable Interest Entities Subsections, the term *related parties* includes those parties identified in Topic **850** and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. All of the following are considered to be de facto agents of a reporting entity:

- a. A party that cannot finance its operations without **subordinated financial support** from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary
- b. A party that received its interests as a contribution or a loan from the reporting entity
- c. An officer, employee, or member of the governing board of the reporting entity
- d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.
- e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

810-10-25-44 In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph **810-10-25-38A** but, as a group, the reporting entity and its related parties (including the de facto agents described in the preceding paragraph) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

- a. The existence of a principal-agency relationship between parties within the related party group
- b. The relationship and significance of the activities of the VIE to the various parties within the related party group
- c. A party's exposure to the variability associated with the anticipated economic performance of the VIE
- d. The design of the VIE.

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4. ED10 includes the following proposals regarding related parties:

Parties that act for the reporting entity

B12 The following are examples of parties that often act for the reporting entity:

- (a) the reporting entity's related parties as defined in IAS 24 *Related Party Disclosures*.
- (b) a party that received its interest in the entity as a contribution from the reporting entity.
- (c) a party that has agreed not to sell, transfer or encumber its interests in the entity without the prior approval of the reporting entity.
- (d) a party that cannot finance its operations without financial support from the reporting entity.
- (e) an entity with the same board of directors as the reporting entity.

Staff analysis

5. We believe that an agency relationship does not necessarily need to involve a contractual arrangement, but could also be the result of an implicit arrangement. The nature of the relationship between a reporting entity and its related parties might be such that the related party is acting on behalf of the reporting in relation to its involvement with another entity. If a related party is acting on behalf of a reporting entity, we view this as a non-contractual agency relationship.

When assessing control, should a reporting entity consider the involvement that a related party has with another entity as its own?

6. We think that, when assessing control, a reporting entity should consider the nature of its relationship with related parties to assess whether that relationship is such that the related party (or parties) is acting on behalf of the reporting entity. We would conclude that this is the case when the relationship is such that the reporting entity, or those that direct the activities of the reporting entity, are able to direct the related party to act on behalf of the reporting entity in relation to its involvement with the other entity.
7. Many respondents to ED10 argued that the examples in paragraph B12 (reproduced in paragraph 4 of this paper) were not helpful because they could

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think of circumstances when it would appropriate to consider each of the parties to be agents of the reporting entity and other circumstances when it would not.

8. The following issues were identified:
 - (a) ED10 states that the reporting entity's related parties as defined in IAS 24 *Related Party Disclosures* are examples of parties that often act for reporting entity. Subtopic 810-10 includes a similar reference to related parties as defined in Topic 850, *Related Party Disclosures*. Many respondents to ED10 noted that only some of the related parties listed in IAS 24 are likely to act for the reporting entity. In particular, they noted that an associate or jointly controlled entity would not necessarily act for the reporting entity because the reporting entity, by definition, does *not* control those entities.
 - (b) Another example of a de facto agent in the ED is that of a party that has agreed not to sell, transfer or encumber its interests in the entity without the prior approval of the reporting entity. One respondent to ED10 noted that most venturers to a joint arrangement would fit this description, but those co-venturers would not necessarily act for each other.
9. We agree with the observations made by those respondents to ED10. However, we would note that it was never the IASB's intention that those parties listed as related parties in ED10 would be assumed to *always* act for the reporting entity—a reporting entity would be required to look more closely at the closeness of such relationships and assess whether the related party is acting for the reporting entity.
10. Other than specifically excluding certain related parties from the analysis performed under paragraph 810-10-55-37 to determine if a decision making arrangement represents a variable interest and amending which parties are considered de facto agents, the amendments to Subtopic 810-10 by Statement 167 did not modify how related parties are viewed in the consolidation assessment performed under Interpretation 46(R), *Consolidation of Variable*

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Interests. Accordingly, Subtopic 810-10, as amended by Statement No.167, assumes that those parties *always* act for the reporting entity.

11. To assume that all related parties listed in ED10 and Subtopic 810-10 would *always* act for the reporting entity would seem inappropriate. Some of those parties (in particular associates, joint ventures, and some pension plans) are not controlled by the reporting entity. Those parties could be controlled by another party that is not obliged to act according to the wishes of the reporting entity (and may be prevented from acting according to the wishes of the reporting entity if it were detrimental to the investors or shareholders of the entity).
12. On the other hand, we think that it would not be appropriate to remove the guidance on related parties and, therefore, imply that a reporting entity's related parties would *never* act on behalf of the reporting entity.
13. To address the issues raised, we recommend the following:
 - (a) to include the principle that the involvement and interests of a related party should be considered to be those of the reporting entity when assessing control in situations in which the nature of the reporting entity's relationship with that related party is such that the related party is acting on behalf of the reporting entity. We would conclude that this is the case when the relationship is such that the reporting entity, or those that direct the activities of the reporting entity, have the ability to direct the related party to act on behalf of the reporting entity in relation to its involvement with the other entity.
 - (b) to include a list of examples of parties that, by the nature of their relationship, are more likely to act for the reporting entity, rather than stating that those parties always act on behalf of the reporting entity. The assessment of whether the nature of the relationship between the reporting entity and the related party is such that the related party acts for the reporting entity would require judgement, including consideration of the nature of the relationship and the way that the parties interact with each other.

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Who should be considered to be related parties?

14. Respondents to ED10 identified the following issues regarding the list of related parties included in paragraph B12:

- (a) The ED states that a party that cannot finance its operations without financial support from the reporting entity would often act for the reporting entity. We agree with those respondents that argued that many operating entities depend on bank loans, but that this would not necessarily imply that those entities act as agents of their banks.

We would propose to address this issue by clarifying in the IASB consolidation standard that a party would often act for the reporting entity only if it cannot finance its operations without subordinated financial support from the reporting entity. This wording is the same as is currently in Subtopic 810-10, as amended by Statement 167.

- (b) Subtopic 810-10, as amended by Statement 167, includes ‘a party that has a close business relationship like the relationship between a professional service provider and one of its significant clients’ as a de facto agent. ED10 did not include such a party as an example of those that often act for the reporting entity.

We would propose to include such a party to the list of related parties in the consolidation standard.

15. The recommendations included in paragraph 14 of this paper would align the parties listed as related parties in the IASB consolidation standard with those in Subtopic 810-10, as amended by Statement 167, with one exception. ED10 proposes that ‘an entity with the same board of directors as the reporting entity’ is considered to be a related party. The IASB staff propose to retain such an entity as a related party but to clarify that such a related party need only have a majority of its board of directors (or governing body) be the same as that of the reporting entity. The FASB staff does not believe that this additional party should be listed as a related party because entities with the same board of directors would typically be considered related parties under one of the other parties listed.

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Guidance on what to do when a related party is deemed to act for the reporting entity

16. ED10 includes a list of those parties that often act for the reporting entity but did not address what the reporting entity should do if it concludes that any of those parties act for the reporting entity. Some respondents to ED10 questioned the purpose of the list of related parties because it was not clear what the consequences were of concluding that a party was a related party of the reporting entity.
17. Paragraph 810-10-25-44 of the Accounting Standards Codification (reproduced in paragraph 3 of this paper) includes such guidance. We would recommend including similar guidance in the IASB consolidation standard as follows:

When a reporting entity concludes that the nature of its relationship with a related party (or parties) is such that the related party is acting on its behalf, the involvement and interests that the reporting entity and the related party have in another entity are considered together when assessing control of that entity.

In situations in which the reporting entity or any of its related parties alone control another entity, that controlling entity would consolidate the controlled entity in question.

In situations in which the reporting entity and its related parties, as a group, control another entity, the entity (within the related party group) that is most closely associated with the controlled entity would consolidate that entity.

The determination of which party within the related party group is most closely associated with the controlled entity requires judgement—the determination would include consideration of the following factors:

- (a) the existence of a contractual principal-agent relationship between the entities within the related party group.
- (b) the relationship and significance of the activities of the controlled entity to the various entities within the related party group.
- (c) an entity's exposure to the variability associated with the expected returns generated by the activities of the controlled entity.
- (d) the design of the controlled entity.

Staff paper

Questions for the boards

1. Do the boards agree that, when assessing control, the involvement and interests of a related party should be considered to be those of the reporting entity when the nature of the reporting entity's relationship with that related party is such that the related party is acting on behalf of the reporting entity. We would conclude that this is the case when the relationship is such that the reporting entity, or those that direct the activities of the reporting entity, have the ability to direct the related party to act on behalf of the reporting entity in relation to its involvement with the other entity.
2. Do the boards believe that the list of potential related parties should include an entity for which the majority of the members of its governing body is the same as that of the reporting entity?
3. Does the IASB agree with the staff recommendations in paragraph 14 of the paper to clarify those parties included as examples of related parties?
4. Does the IASB agree with the staff recommendation to add the guidance in paragraph 17 of the paper that addresses what to do when a related party is acting on behalf of the reporting entity?