

# Invitation to Comment

## Related Party Transactions — Definition and Disclosure

Prepared by:  
Public Sector Accounting Board

October 2011

Comments are requested by November 14, 2011

# PSAB

## **Commenting on this Invitation to Comment**

This Invitation to Comment is issued by the Public Sector Accounting Board. The members of the Board are drawn from government, public accounting practice, business and academe. All members serve as individuals, not as representatives of their governments, employers or organizations.

This Invitation to Comment presents key principles that the Board expects to include in a future exposure draft.

Individuals, governments and organizations are invited to send written comments to the Board on this Invitation to Comment. Comments are most helpful if they clearly identify the preferred alternative supported by their reasoning.

All comments received will be available on the website at [www.psab-ccsp.ca](http://www.psab-ccsp.ca) shortly after the comment deadline, unless confidentiality is requested.

For your convenience, a PDF [response form](#) has been posted with this document that can be downloaded here. You can save the form both during and after completion for future reference. You are not restricted by the size of the interactive comment fields in the response form and there is also a general comments section.

Alternatively, you may send written comments by e-mail in Word format to:  
[ed.psector@cica.ca](mailto:ed.psector@cica.ca)

**To be considered, comments must be received by November 14, 2011, addressed to:**

**Tim Beauchamp, Director  
Public Sector Accounting  
The Canadian Institute of Chartered Accountants  
277 Wellington Street West  
Toronto, Ontario M5V 3H2**

## Highlights

The Public Sector Accounting Board (PSAB) proposes, subject to comments received on this Invitation to Comment and following its due process, to expose a proposed new Section on related party transactions. The Section would apply to governments and those government organizations that base their accounting policies on the CICA Public Sector (PSA) Handbook.

This Invitation to Comment is accompanied by an Issues Paper, “Related Party Transactions — Recognition and Measurement,” that seeks your views on recognition and measurement of related party transactions in separate financial statements of public sector entities. The Issues Paper evaluates the need to recognize and measure related party transactions in accordance with the PSA Handbook. You are asked to consider and comment on the issues identified. In order to assist PSAB understand the nature and breadth of intra-organizational transactions encountered by public sector entities, you are also asked to provide specific practical examples as well as current accounting practice in regard to their recognition and measurement in separate financial statements.

## Main features

The main features of this Invitation to Comment are as follows:

- Related parties include entities that control or are controlled by another entity, entities that are under common control and entities that have shared control over or that are subject to shared control.
- A related party includes individuals that are members of key management personnel and close members of their family. Details of compensation arrangements, expense allowances and other similar payments are excluded from disclosure requirements.
- The reporting entity would disclose the nature of the relationship with related parties and the types of related party transactions that have occurred including those for which no amount has been recognized and the amounts involved related to the transaction.
- Related party transactions that occur in the normal course of operations and at arm’s length are excluded from the disclosure requirements.
- An entity would provide information about significant unrecognized related party transactions in sufficient detail to enable users of the entity’s financial statements to understand the impact they have had on its financial position and performance.

## Comments requested

PSAB welcomes comments on all aspects of the Invitation to Comment. Comments are most helpful if they relate to a specific preliminary view, paragraph or group of paragraphs and, when expressing disagreement, they clearly explain the problem and indicate a suggestion, supported by specific reasoning, for alternative wording.

In particular, respondents are requested to provide responses to the following questions including reasons for agreeing or disagreeing with the preliminary views outlined in this Invitation to Comment:

1. Do you agree that related parties include an entity that, directly or indirectly, controls or is controlled by, the reporting entity?
2. Do you agree that related parties include the reporting entity and other entities that are under common control?
3. Do you agree that related parties include entities that have shared control over, or that are under the shared control of, the reporting entity?
4. Do you agree that related parties do not include entities that have significant influence over or are significantly influenced by the reporting entity?
5. Do you agree that a related party includes an individual that is a member of the key management personnel?
6. Do you agree that a related party includes individuals that are close members of the family of a member of the key management personnel of a reporting entity?
7. Do you agree that disclosure of related party relationships is not required when there have been no transactions between the related parties?
8. Do you agree with the disclosure requirements in respect of related party transactions?
9. Do you agree that related party transactions that occur within a normal course of operations and at arm's length be excluded from disclosure requirements?
10. Do you agree that an entity should disclose information about unrecognized related party transactions?
11. Do you agree that disclosure of key management personnel compensation arrangements, expense allowances and other similar payments is not required in financial statements?

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## PURPOSE AND SCOPE

- .01 The purpose of this Invitation to Comment is to seek feedback on a proposed standard for the disclosure of information about transactions between the entity and its related parties necessary for users to understand the effect that those transactions may have had on its financial position and performance.
- .02 The proposals in this Invitation to Comment would apply to those entities that, for the purposes of their financial reporting, are required or choose to base their accounting policies on the CICA Public Sector (PSA) Handbook. They do not apply to government business enterprises or other entities that adhere to the standards applicable to publicly accountable enterprises in Part I of the CICA Handbook – Accounting.
- .03 This Invitation to Comment provides PSAB’s preliminary views on proposed standards that should be applied in:
- (a) identifying related parties of a reporting entity;
  - (b) identifying the circumstances in which disclosure of transactions between a reporting entity and its related parties is required; and
  - (c) determining the information to be disclosed about those transactions.
- PSAB is still analyzing the need for inclusion of standards that should be applied in recognition and measurement of related party transactions. (See accompanying Issues Paper.)
- .04 This Invitation to Comment does not deal with:
- (a) special purpose reports issued by an entity;
  - (b) amalgamations and restructurings;
  - (c) inter-government transactions;
  - (d) transactions within a consolidated reporting entity;
  - (e) cost-sharing arrangements; and
  - (f) ownership interests in a public sector entity held by individuals.

### Special purpose reports

- .05 Entities produce many kinds of financial reports in addition to general purpose financial reports. These reports may be prepared by individual entities to comply with legislation or to measure and report on the performance of individual funds, programs and activities. They may be special purpose reports designed to meet particular needs of specific users.
- .06 The PSA Handbook does not discuss objectives of the applicable financial reporting framework for the preparation and presentation of special purpose financial statements or other financial reports published by an entity. The standards in the PSA Handbook are designed to apply to the general purpose financial statements of all public sector entities. General purpose financial statements are financial statements designed to meet the common information needs of external users of financial information about a public sector entity.

Nevertheless, an entity preparing a special purpose report is not precluded from applying these proposals.

### **Amalgamations, restructurings and acquisitions**

- .07 Amalgamation activities occur at and within all levels of government for various reasons. They generally involve two or more entities that are separate entities not under common control. In many of the amalgamation activities, it may not be possible to identify an acquirer. Further, because an amalgamation involves a number of other issues that need to be addressed, amalgamations are beyond the scope of this Invitation to Comment.
- .08 Governments frequently reorganize and restructure for policy and financial reasons. New government organizations are created from the transfer of existing government resources. Government responsibilities and related resources are reallocated among government departments, ministries and government organizations. Often restructuring activities involve organizations under common control and do not involve an exchange of consideration. While some restructuring issues may be similar, such as measurement, there are other disclosure issues that have not been considered and are beyond the scope of this project.
- .09 The PSA Handbook addresses accounting for an acquisition of a government unit in ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, and the creation and acquisition of a government business enterprise in INVESTMENTS IN GOVERNMENT BUSINESS ENTERPRISES, Section 3070. The purchase method prescribed in these Sections require identification of an acquirer and measuring the assets acquired and liabilities assumed at fair value at the date of acquisition. Because the PSA Handbook already provides guidance on acquisitions, it is beyond the scope of this Invitation to Comment.
- .10 For the purposes of this Invitation to Comment, transactions regarding amalgamation or restructuring of organizations and acquisitions are not considered to be related party transactions.

### **Inter-government transactions**

- .11 The federal, provincial, territorial and local governments are separate financial reporting entities and would be excluded from the financial reporting entity of any other government. Given the sovereign nature of the federal and provincial governments, the nature of the arrangements between the federal government and the territories, and the level of influence exercised over local governments by their provincial governments, the proposals in this Invitation to Comment are not intended to apply to the relationship and transactions between these separate levels of government.

## **Consolidated financial statements**

- .12 Financial statements for the government reporting entity as a whole are prepared to provide an understandable overview of the full nature and extent of the financial affairs and resources that the government controls. Reporting on a consolidated basis presents summary information that aggregates the individual financial statements of organizations comprising the government reporting entity. Similarly, a government organization that adopts the standards for the public sector in the PSA Handbook for the purposes of preparing their separate financial statements would include the financial position and results of organizations that it controls.
- .13 The purpose of consolidated financial statements is to present the effects of transactions of the reporting entity with organizations and individuals external to that entity. Consolidation combines the accounts of government organizations, with the exception of government business enterprises, line-by-line on a uniform basis of accounting and eliminates inter-organizational balances and transactions. The mechanics of preparing government consolidated financial statements are outlined in BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500, and ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510.
- .14 With the exception of those entities that are government business enterprises, related party transactions within a consolidated reporting entity are eliminated in consolidated financial statements of that reporting entity. Therefore, these transactions will not have an effect on the financial position or results of operation of that consolidated reporting entity.

## **Cost-sharing arrangements**

- .15 This Invitation to Comment does not deal with accounting for and reporting transactions related to cost-sharing arrangements between two or more government entities for a contract with external third parties. For example, a group of hospitals within a jurisdiction may enter into a contract for uniform supply. Each hospital is responsible for its proportion of the contract. The contract may be administered by a central agency or one of the parties to the contract.
- .16 Parties to a cost-sharing arrangement are not related parties simply due to their participation in a contract with an external third party. The proposals in this Invitation to Comment would be considered to determine whether the parties are related.

## **Ownership interests in public sector entities held by individuals**

- .17 A survey of the requirements of other authoritative standard setters indicates that most include individuals and close members of the family of that individual owning, directly or indirectly, an interest in the reporting entity that would give

them control, joint control or significant influence over the financial and operating decisions of the entity. This Invitation to Comment does not address ownership interests held by individuals since it is unlikely to occur in the public sector.

## NEED FOR A STANDARD

- .18 Governments commonly conduct activities necessary for the achievement of different components of their responsibilities and objectives through separate entities they, directly or indirectly, control.<sup>1</sup> Similarly, individual entities within a government reporting entity<sup>2</sup> may conduct activities through controlled entities.
- .19 Governments establish different operating relationships between government organizations that allow them to operate together to achieve the common objectives of the government for the delivery of services. Governments establish individual policies regarding inter-organizational arrangements that reflect a government's policy objectives, accountability structures and budgetary practices. It is not unusual in the government operating environment for transactions between government organizations to occur at cost, less than cost or without charge. For example, one organization may provide administrative services such as centralized procurement to other organizations without charge or below cost.
- .20 Both the ability of one entity to control the financial and operating policies adopted by another entity, and policies regarding inter-organizational arrangements, could have a material effect on the financial position and performance reported by an entity in its financial statements.
- .21 Other standard setters<sup>3</sup> have established related party disclosure standards with various objectives. There is some commonality among the objectives, both in the private and public sectors.
- .22 The International Public Sector Accounting Standards Board (IPSASB), in International Public Sector Accounting Standard (IPSAS) 20, *Related Party Disclosures*, states that related party relationships are a normal feature of government activities. Government departments and agencies often operate together to achieve the policies of the government. Government departments and agencies are subject to the overall direction of the executive government and,

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<sup>1</sup> See GOVERNMENT REPORTING ENTITY, Section PS 1300, for the definition of control.

<sup>2</sup> In the PSA Handbook, a government reporting entity is comprised of the organizations that are controlled by the government. This Invitation to Comment also uses the term reporting entity, which refers to an entity that is preparing financial statements based on accounting principles in the PSA Handbook. The reporting entity may be a government reporting entity or government organization that is preparing separate financial statements.

<sup>3</sup> Other standards considered include those of the AcSB International Financial Reporting Standards (IFRSs) for publicly accountable enterprises, profit-oriented enterprises and not-for-profit organizations), the AASB, the IASB, the IPSASB, the FASB and the AICPA.

ultimately, legislatures or councils. Similarly, government departments and agencies may conduct activities necessary for the achievement of different components of their responsibilities and objectives through separate controlled entities. Ministers and other elected officials, appointed members of the government or a senior management group can exert influence over the operations of a department or agency.

- .23 The International Accounting Standards Board (IASB), in International Accounting Standard (IAS) 24, *Related Party Disclosures* states that related party relationships are a normal feature of commerce and business. For example, entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates. In those circumstances, the entity has the ability to affect the financial and operating policies of the investee through the presence of control, joint control or significant influence. An entity's financial position and profit or loss may be affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties. Related parties may enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Also, transactions between related parties may not be made at on the same terms as between unrelated parties.
- .24 The Canadian Auditing and Assurance Standards Board (AASB), in Canadian Auditing Standard (CAS) 550, "Related Parties," states that, although many related party transactions are in the normal course of business, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example, the use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions for fraudulent purposes. Similarly, evidence of a related party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting. Consideration of such behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud.
- .25 Generally, all standard setters conclude that the existence of related party relationships provide the opportunity for transactions to occur on a basis that may advantage one party at the expense of another. Disclosures describing relationships and transactions with entities are required by users of financial statements. Knowledge of an entity's transactions, outstanding balances including commitments, and relationships with related parties, may affect assessments of its operations by users of financial statements, including assessments of the risks and opportunities facing the entity.
- .26 Relevant information is omitted if disclosures about significant transactions with related parties are not included in financial statements. Related party transactions

may result in operating results or a financial position significantly different from that which would have been obtained if the related parties were autonomous. Disclosure of information about related parties helps users of financial statements form predictions and analyze the extent to which those statements may have been affected by related parties.

- .27 There is a general presumption that transactions reflected in financial statements have been consummated on an arm's length basis between independent parties. However, when related party transactions exist, the terms of the transactions may be arranged to obtain certain results desired by the related parties and, therefore, may not represent what they usually would be expected to represent.
- .28 Information about transactions with related parties assists users when comparing an entity's financial position and results of operations with those of other entities for that government as well as other jurisdictions, and with its performance and accountability objectives. Although it is difficult in many situations where a transaction has occurred with related parties for users to determine the terms on which the transaction might have occurred if the parties were unrelated, disclosure of information about transactions with related parties helps users detect and explain possible differences or evaluate their significance to the performance of the entity.

#### **Preliminary View 1**

Public sector entities should disclose related party transactions in their general purpose financial statements.

## **DEFINING A RELATED PARTY**

- .29 Standard setters have defined a related party to be an entity or an individual (person) that is related to the reporting entity. Definitions generally also include a close member of the family of an individual that is a related party.

### **Entities**

- .30 The following characteristics have been identified in various definitions of a related party:
- (a) entities that, directly or indirectly, control or are controlled by the reporting entity;
  - (b) the reporting entity and other entities that are subject to common control;
  - (c) entities that, directly or indirectly, have shared control over or are subject to shared control of the reporting entity; and
  - (d) entities that, directly or indirectly, have significant influence over or are significantly influenced by the reporting entity.

## Control

- .31 The elements of the definition of control are consistent among standard setters. IASB defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The Canadian Accounting Standards Board (AcSB) has a similar definition except that control is the continuing power to determine an enterprise's strategic operating, investing and financing policies without the cooperation of others. The US Financial Accounting Standards Board (FASB) defines control as 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.
- .32 GOVERNMENT REPORTING ENTITY, paragraph PS 1300.08, defines control as the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities. Financial and operating policies are principles and practices that determine how an organization conducts its activities. The ability to govern these policies is an important element of government control because it establishes the fundamental basis for the conduct of the organization's operations and the achievement of its mission and mandate.
- .33 Given the ability of one organization to control another by virtue of having the power to govern the financial and operating policies of another, one entity can, directly or indirectly, affect the financial position and results of another organization.

### **Preliminary View 2**

Related parties include an entity that, directly or indirectly, controls or is controlled by, the reporting entity.

Whether an entity is controlled by another entity is a question of fact to be determined in each circumstance considering the definition of control and the indicators of control in GOVERNMENT REPORTING ENTITY, PS 1300.

## Common control

- .34 Governments commonly carry out their policies and deliver services through various entities such as departments, ministries, boards, commissions and Crown corporations. Although some entities may have more discretion than others in establishing their systems and practices, they may be bound by directives and guidelines of the government that affect both the way in which they operate to achieve their individual objectives and with other entities in achieving common or collective objectives of the government.
- .35 Entities under common control may enter into transactions that they would not enter into if they were operating autonomously or may agree to transactions on different terms and conditions than those that would be available to unrelated

parties because they are subject to the overall direction of the government and, ultimately, legislatures or councils. Transactions may occur on a basis that advantages one party inappropriately at the expense of another. For example, it is common for goods and services to be transferred between departments at less than full cost recovery as a part of normal operating procedures established by the government.

- .36 Given the ability of an entity to control the financial and operating policies adopted by entities under its common control, the reported financial position and operating results in the separate financial statements of the entities could be significantly different from that which would have been obtained if the entities were autonomous. Disclosure of information about the transactions, the terms on which they took place and the relationship underlying them is necessary for users to better understand the separate financial statements and the extent to which those statements may have been affected by them.

### **Preliminary View 3**

Related parties include the reporting entity and other entities that are under common control.

### **Shared control**

- .37 The elements of the definition of shared control are consistent among standard setters. The IASB and IPSASB both define joint control as the contractually agreed sharing of control over an economic activity. The AcSB states that joint control of an economic activity is the contractually agreed sharing of the continuing power to determine its strategic operating, investing and financing policies. The FASB says joint control occurs if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners.
- .38 GOVERNMENT PARTNERSHIPS, paragraph PS 3060.11, describes shared control as two or more partners bound by a contractual arrangement that establishes shared control over a government partnership.
- .39 If one of the partners is a reporting entity and is required to include that organization in its own financial statements (i.e., a share of the financial position and results of the partnership), the decisions of the partners can, directly or indirectly, affect the financial position and results of the reporting entity. Parties to the contractual arrangement would not be related parties simply because the partners share control of decisions related to the financial and operating policies of the partnership on an ongoing basis.

#### **Preliminary View 4**

Related parties include entities that have shared control over, or that are under the shared control of, the reporting entity.

#### **Significant influence**

- .40 Significant influence is defined consistently among various standard setters. IPSASB and the IASB define significant influence as the power to participate in the financial and operating policy decisions of the investee, but not control over those policies. The FASB defines significant influence as the ability to exercise significant influence over operating and financial policies of an investee. The AcSB states that significant influence over an enterprise is the ability to affect the strategic operating, investing and financing policies of the enterprise.
- .41 The term significant influence, as used by other standard setters, is generally an accounting term that determines how a reporting entity accounts for an ownership interest in another entity. When an investor's ownership interest is in the form of shares and it holds, directly or indirectly, 20 percent or more of the voting power of the investee, it is presumed that the investor has significant influence over the financial and operating policies of the investee. The investment is accounted for using the equity method. IPSASB, the IASB, the AcSB and the FASB require disclosure of related parties and related party transactions involving entities that are accounted for using the equity method. Application of the equity method means transactions between an investor and investee can affect the net assets and profit or loss of the investor. Disclosure is essential to users' understanding and assessment of the impact of the relationship and transactions on the financial position and results presented in the financial statements of the reporting entity.
- .42 The PSA Handbook does not include the concept of significant influence. An equity investment that is other than a controlling interest is generally measured at fair value when quoted in an active market (as it is a portfolio investment). The modified equity method is only used in the PSA Handbook to account for an equity investment that qualifies as a government business enterprise or for an interest in a government business partnership.
- .43 IPSASB, the IASB and the AcSB broaden the definition of significant influence in their standards on related party disclosures. All state that significant influence may be gained by an ownership interest, statute or agreement. The IASB and the AcSB state that existence of significant influence is usually evidenced in one or more ways including:
- (a) representation on the board of directors or equivalent governing body;
  - (b) participation in the policy making process;
  - (c) material transactions between the entities;
  - (d) interchange of managerial personnel; or
  - (e) provision of technical information.

Similarly, the FASB states that, in addition to having significant influence as a result of an ownership interest, another party also is a related party if it can significantly influence the management or operating policies of the transacting parties to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

.44 The AcSB, in RELATED PARTY TRANSACTIONS, Section 3840, states that the degree of influence that one party may exert on another is a major factor in determining whether they are related. In some cases, the degree of influence may be so remote that they need not be considered related. For example, two companies may be unrelated even though one director serves on the board of each company; in such a case, the degree of influence exercised by the director over the strategic policies of each company determines whether the companies are related.

.45 IPSASB takes a slightly different approach. It states that 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:

- (a) the policy making process;
- (b) material transactions between entities within an economic entity;
- (c) interchange of managerial personnel; or
- (d) dependence on technical information.

As well, in the public sector, an individual or entity may be given oversight responsibility for a reporting entity. Oversight means the supervision of the activities of an entity with the authority and responsibility to control, or exercise significant influence over, the financial and operating decisions of the entity. IPSASB also defines significant influence to encompass entities subject to joint control.

.46 Although significant influence, as defined by other standard setters, has no accounting application for the PSA Handbook, it may have relevance for a related party disclosure standard. For example, the ability of a reporting entity to participate in the financial and operating policy decisions of an investee as a result of its representation on the governing body may impact its reported financial position and performance. Disclosure of information may be essential to users' understanding and assessment of the impact of the relationship and transactions on the financial position and results presented in the financial statements of the reporting entity.

.47 In deciding whether significant influence should be included as a characteristic of a related party, PSAB considered the fact that governments exercise significant influence over the financial and operating policies of a broad range of entities, in both the private and public sector, through statutes and agreements.

.48 An entity's ability to regulate the activities of another entity does not, in and of itself, constitute significant influence. Entities may establish the regulatory environment in an industry or sector within which organizations operate and

impose conditions or sanctions on their operations. The governing bodies of those regulated organizations make independent decisions within the regulatory framework. The entity's interest in these organizations extends only to the regulatory aspects of operations.

- .49 Whether a public sector entity has significant influence over another entity is a question of fact that must be determined by reference to the definition of significant influence and the particular circumstances of each case. The determination of the fact that significant influence exists will require the exercise of professional judgment considering the indicators of significant influence.
- .50 Significant influence can be gained by an ownership interest, statute or agreement. Consideration also needs to be given to the nature of the relationship between entities in order to determine whether significant influence exists. The existence of significant influence may be evidenced by, but is not limited to, one of the following ways:
- (a) representation on the board of directors or equivalent governing body;
  - (b) participation in the policy making process;
  - (c) material transactions between the public sector entity (or other public sector entities under the control of the public sector entity or common control of the government reporting entity) and the investee;
  - (d) interchange of managerial personnel; or
  - (e) provision of essential technical information.
- .51 PSAB is of the view that a related party does not include entities that have significant influence over, or are subject to the significant influence of, another entity. Public sector entities (in particular, governments), have wide ranging powers that would typically allow them to exert significant influence over the operating and financial policies of a broad range of parties in all sectors of the economy. Moreover, the notion of significant influence over entities does not give rise to equity accounting for associate entities and PSAB does not believe it necessary to introduce significant influence when defining a related party.

#### **Preliminary View 5**

Related parties do not include entities that, directly or indirectly, have significant influence over or are significantly influenced by the reporting entity.

## **Individuals**

### **Key management personnel**

- .52 A survey of the requirements of other authoritative standard setters indicates that most include key management personnel in the definition of related parties.

Key management personnel are generally defined as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including:

- (a) all directors or members of the governing body of the entity (at the whole-of-government level, the governing body may consist of elected or appointed representatives such as ministers, councillors, aldermen);
- (b) the senior management of the reporting entity, including the chief executive or permanent head and senior management group of the reporting entity; and
- (c) any other persons having the authority and responsibility for planning, directing and controlling the activities of the reporting entity.

.53 In addition, an entity may be related to the reporting entity if a member of its key management personnel or a close member of the family of that individual:

- (a) has control or shared control over the entity;
- (b) holds an ownership interest that allows the individual to participate in the financial and operating decisions of the entity;
- (c) is a member of the board of directors or other governing body of the entity that allows the individual to participate in the financial and operating decisions of the entity; or
- (d) is a member of the management of the entity.

.54 IPSASB, in IPSAS 20, *Related Party Disclosures*, states that when an entity is subject to oversight of an elected or appointed representative of the governing body of the government to which the entity belongs, that person and, in some cases key advisors of that person, are related parties if the oversight function includes the authority and responsibility for planning, directing, and controlling the activities of the entity. Key advisors are deemed to be key management personnel when they have a special working relationship with an individual who has control and, as such, they may have access to privileged information and may also be able to exercise control or significant influence.

.55 IPSASB has included key management personnel because 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. They are responsible for the strategic direction and operational management of an entity, and are entrusted with significant authority. Their responsibilities may enable them to influence the benefits of office that flow to them or their related parties.

.56 An argument has been made that it is not necessary that a Canadian standard on related party transactions include key management personnel since most jurisdictions in Canada have financial disclosure and conflict of interest and integrity legislation. The statutes and regulations commonly require elected and certain appointed officials of public sector bodies to make financial disclosures of assets, debts and sources of income. The statutes and regulations govern the process of when and how an individual should make disclosure of financial

information. The intent of the legislation is to identify what areas of influence and possible financial benefit an elected official, nominee or designated employee might have by virtue of their office, and to ensure the public has reasonable access to the information.

- .57 Related parties such as controlled entities, principal stockholders or management can execute transactions that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure. They can even defraud the entity by transferring funds to conduit related parties and ultimately to perpetrators.
- .58 An argument has been made that it is inconsistent with the purpose of general purpose financial statements to include disclosures of the nature of relationships and transactions with individuals who are members of the key management personnel. First, the objective of financial statements in the public sector is to communicate financial information that provides an accounting of the administration of the financial affairs and resources of a government or government organization. The purpose is not to report on relationships and transactions with key management personnel because they are entrusted with significant authority that may enable them to influence the benefits of office that flow to them or their related parties. Secondly, information provided in financial reports is, of necessity, highly aggregated in nature in order to serve the interests of a variety of users. Many of transactions with key management personnel would fall below thresholds for materiality. Finally, financial statements cannot be expected to fulfil all of the users' needs served by a public sector entity's financial reporting system. This information is better provided, or can only be provided, in reports other than financial statements.
- .59 However, PSAB is of the view that a related party includes key management personnel because of the fiduciary responsibilities of elected and appointed officials and because they have extensive powers over the deployment of the economic resources of a public sector entity. They are responsible for the strategic direction and operational management of an entity, and are entrusted with significant authority.
- .60 As well, many other government organizations are in the process of, or will be, changing the GAAP that they use when preparing their own entity level financial statements as a result of changes made to the Introduction to Public Sector Accounting Standards in the PSA Handbook. Not all of these organizations come under financial disclosure and conflict of interest and integrity legislation applicable to governments, government departments and agencies.
- .61 PSAB is of the view that a related party includes an individual that is a member of the key management personnel of a reporting entity. Key management personnel are defined as those persons having authority and responsibility for

planning, directing and controlling the activities of the entity, directly or indirectly, including:

- (a) all directors or members of the governing body of the entity (at the whole-of-government level, when the governing body may consist of elected or appointed representatives such as ministers, councillors, aldermen);
- (b) the senior management of the reporting entity, including the chief executive or permanent head and senior management group of the reporting entity; and
- (c) any other persons having the authority and responsibility for planning, directing and controlling the activities of the reporting entity.

#### **Preliminary View 6**

A related party includes:

- (a) an individual that is a member of the key management personnel of a reporting entity;
- (b) an entity controlled by or under the shared control of a member of key management personnel of a reporting entity; or
- (c) an entity when a member of the key management personnel of a reporting entity is a member of the governing body or management of the entity such that they have the ability to participate in the financial and operating policy decisions of the entity.

Key management personnel is an individual having, directly or indirectly, authority and responsibility for planning, directing and controlling the activities of the entity.

#### **Close family members of key management personnel**

- .62 Most standard setters have defined a related party to include individuals that are close members of the family of key management personnel. Close members of the family of an individual are close relatives of the individual or members of the individual's immediate family who can be expected to influence, or be influenced by, that individual in their dealings with reporting entity.
- .63 Standard setters generally state that the exercise of professional judgment is required in determining whether an individual should be identified as a close member of the family of an individual that is a member of key management personnel. In the absence of information to the contrary, the following immediate family members and close relatives are presumed to have, or be subject to, such influence as to satisfy the definition of close members of the family of an individual:
  - (a) a spouse, domestic partner, dependent child or relative living in a common household;
  - (b) a grandparent, parent, nondependent child, grandchild, brother or sister; and
  - (c) the spouse or domestic partner of a child, a parent-in-law, a brother-in-law or a sister-in-law.

- .64 In addition, an entity may be related to the reporting entity if a close family member of its key management personnel:
- (a) has control or shared control over the entity;
  - (b) holds an ownership interest that allows the individual to participate in the financial and operating decisions of the entity;
  - (c) is a member of the board of directors or other governing body of the entity that allows the individual to participate in the financial and operating decisions of the entity; or
  - (d) is a member of the management of the entity.
- .65 PSAB is of the view that a related party include individuals that are close members of the family of key management personnel. PSAB is also of the view that close members of the family of an individual that is a member of key management personnel can influence, or be influenced by, that individual in their dealings with reporting entity. Individuals that are members of key management personnel are responsible for the strategic direction and operational management of an entity, and are entrusted with significant authority. Their responsibilities may enable them to influence the benefits of office that flow to them or close members of their family.
- .66 PSAB is of the view that a close family member includes:
- (a) a spouse, domestic partner, dependent child or relative living in a common household;
  - (b) a grandparent, parent, nondependent child, grandchild, brother or sister; and
  - (c) the spouse or domestic partner of a child, a parent-in-law, a brother-in-law or a sister-in-law.
- .67 PSAB is of the view that an entity is a related party if a close member of the family of an individual that is a member of key management of the reporting entity:
- (a) has control or shared control over the entity;
  - (b) holds an ownership interest that allows the individual to participate in the financial and operating decisions of the entity;
  - (c) is a member of the board of directors or other governing body of the entity that allows the individual to participate in the financial and operating decisions of the entity; or
  - (d) is a member of the management of the entity

### **Preliminary View 7**

A related party includes :

- (a) individuals that are close members of the family of key management personnel of a reporting entity; and
- (b) an entity controlled by or under the shared control of a member of a close family member of key management personnel of a reporting entity; or
- (c) an entity when a close family member of key management personnel of a reporting are members of the governing body or management of the entity such that they have the ability to participate in the financial and operating policy decisions of the entity.

Close members of the family of an individual are close relatives of the individual or members of the individual's immediate family who can be expected to influence, or be influenced by, that individual in their dealings with reporting entity.

## **RECOGNITION AND MEASUREMENT**

- .68 Recognition and measurement issues generally arise when related party transactions occur between entities that are part of the same reporting entity. The same issues do not arise when transactions are between, for example, individuals that are members of key management personnel or close members of the family of key management personnel. These transactions would generally be reported at their exchange amount.
- .69 PSAB has deferred a decision on whether a standard should include guidance on the recognition and measurement of intra-organizational transactions that occur between entities that are related as a result of control, common control or shared control. As part of the next phase of its project to develop a standard on related party transactions, PSAB is seeking to better understand how public sector entities currently account for and report intra-organizational transactions.

## **DISCLOSURE**

### **When there are no transactions**

- .70 IPSASB in IPSAS 20, *Related Party Disclosures*, and the IASB in IAS 24 *Related Party Disclosures*, both require disclosure of related party relationships where control exists, irrespective of whether there have been transactions between the related parties. IPSASB states that information about related party relationships 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 cooperates 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 (for example, the transfer of goods and services between departments at less than full cost recovery as a part of normal operating procedures).
- .71 Governments commonly carry out their policies and deliver services through various organizations. Although some may have been delegated broader financial powers and operational authority than others, these organizations are generally bound by directives and guidelines of the government. Similarly, individual entities within a government reporting entity may conduct activities through controlled entities.
- .72 Governments implement different organizational structures within their jurisdictions for the delivery of public services that are reflective of accountability relationships and budget structure. Governments commonly set policies dictating how government organizations conduct their activities that may differ from those that would occur if the parties were unrelated parties. For example, a government can dictate a purchasing policy to a government-controlled organization that it only purchases from certain vendors. In this case, the related party relationship may influence the way in which an entity operates in achieving its individual objectives, and the way in which it cooperates with other related parties in achieving common or collective objectives even though there has not been a related party transaction.
- .73 In recognition of the fact that public sector entities establish differing organizational relationships to achieve common objectives and that such organizational structures are normal within the public sector environment, this Invitation to Comment proposes that disclosure of related party relationships is not required, when there have been no transactions between the related parties.

**Preliminary View 8**

Disclosure of related party relationships is not required when there have been no transactions between the related parties.

**For related party transactions, other than compensation of key management personnel**

- .74 Standard setters are fairly consistent in disclosure requirements. If an entity has had related party transactions during the periods covered by the financial statements, it should 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.

- .75 Related party transaction disclosure standards generally state that an exchange of goods or services between related parties that has not been given accounting recognition is a related party transaction. Such standards require disclosure of information about these transactions. An explanation of the nature of such transactions and the fact that no consideration has been received or paid is useful to explain the effect of the transactions on the reporting entity.
- .76 The AcSB in RELATED PARTY TRANSACTIONS, Section 3840, acknowledges that an exchange of goods or services between related parties may not be given accounting recognition. For example, an enterprise may provide a related party with management services, or use of a patent or license, in the normal course of operations, without receiving consideration in exchange. An explanation of the nature of such a transaction and the fact that no consideration has been received or paid is useful to explain the effect of the transaction on the enterprise.
- .77 In respect of transactions between related parties, standard setters generally require the reporting entity to disclose:
- (a) a description of the nature of the relationship with related parties involved in related party transactions (for example, controlling entity, a controlled entity, an entity under common control, or key management personnel);
  - (b) a description of the types of related party transactions that have occurred including those for which no amount has been recognized;
  - (c) the amounts of the transactions recognized classified by financial statement category; and
  - (d) the amount of outstanding balances and the terms and conditions attached to them.
- .78 IPSAS 20, *Related Party Disclosures*, also requires disclosure of a summary of the broad terms and conditions of transactions with related parties. The disclosures would describe how these terms and conditions differ from those normally associated with similar transactions with unrelated parties. Disclosures of the amount of related party transactions may be expressed either in terms of a specific monetary value or as a proportion of a class of transactions and/or outstanding balances.
- .79 Generally, most standard setters allow that items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

- .80 IPSAS 20 provides two exemptions from disclosure of information about related party transactions other than transactions with key management personnel<sup>4</sup>:
- (a) IPSAS 20 requires disclosure of related party transactions “other than transactions that would occur with a normal or client/recipient relationship on terms and conditions no more or less favourable than those that it is reasonable to expect the entity would have adopted if dealing with that individual or entity at arm’s length...”.
  - (b) IPSAS 20 requires disclosures of related party transactions only when those transactions occur other than in accordance with the operating parameters established in that jurisdiction.
- .81 The exclusion from disclosure provided in (b) above 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. IPSAS 20 requires disclosure of related party transactions only when those transactions occur other than in accordance with the operating parameters established in that jurisdiction.
- .82 The IASB has provided an exemption to a reporting entity that is a government-related entity from the minimum disclosures about related party transactions required of all other entities. A government-related entity is an entity that is controlled, jointly controlled or significantly influenced by a government.
- .83 If a reporting entity applies the exemption under IAS 24 *Related Party Disclosures* it discloses the following about the transactions and related outstanding balances with a government and another entity that is under the common control, joint control or significant influence of a government:
- (a) the name of the government and the nature of its relationship with the reporting entity (for example, 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.
- .84 A reporting entity should disclose sufficient information about related party transactions during the fiscal period covered by the financial statements and the underlying relationships necessary for users to understand the impact of those transactions on the financial position and performance of the entity. Knowledge of a reporting entity’s transactions with related parties and their terms and conditions is necessary for accountability purposes and to allow users to assess

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<sup>4</sup> IPSAS 20 requires the disclosure of information about certain transactions with key management personnel whether or not they have occurred on an arm’s length basis consistent with the operating conditions that apply in respect of the entity.

the cost of services and the management of resources. Disclosure ensures the entity is transparent about its dealings with related parties.

- .85 The exercise of professional judgment is required to determine the level of detail to be disclosed. The reporting entity would consider the closeness of the related party relationship and other factors relevant to establishing the significance of the related party transactions such as whether they are:
- (a) significant in terms of size;
  - (b) carried out on non-market terms; and
  - (c) outside the normal day-to-day business operations of the entity.
- .86 For example, disclosure in the financial statements of a hospital of incidental related party transactions with a university may require less detail than transactions with the ministry of health or another health service provider. The former transactions may be insignificant in terms of amount and the terms may not be outside the normal course of business.
- .87 This Invitation to Comment proposes that, in respect of transactions between related parties, the reporting entity shall disclose:
- (a) a description of the nature of the relationship with related parties involved in related party transactions;
  - (b) a description of the types of related party transactions that have occurred including those for which no amount has been recognized;
  - (c) the amounts of the transactions recognized classified by financial statement category;
  - (d) the amount of outstanding balances and the terms and conditions attached to them; and
  - (e) where conducted on a less than full cost recovery basis and where determinable and significant, the amounts involved.
- .88 Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

#### **Preliminary View 9**

In respect of transactions between related parties, the reporting entity shall disclose:

- (a) a description of the nature of the relationship with related parties involved in related party transactions;
- (b) a description of the types of related party transactions that have occurred including those for which no amount has been recognized;
- (c) the amounts of the transactions recognized classified by financial statement category;
- (d) the amount of outstanding balances and the terms and conditions attached to them; and
- (e) the basis of measurement used.

Items of a similar nature may be disclosed in aggregate.

- .89 In consideration of the volume of related party transactions between public sector entities that may occur in the normal course of operations, this Invitation to Comment proposes that disclosure of information about transactions between related parties and the reporting entity is not required when the transactions occur within a normal supplier or a client/recipient relationship on terms and conditions no more or less favourable than those that it is reasonable to expect the entity would have adopted if dealing with that related party at arm's length in the same circumstances.
- .90 In order to qualify for exemption from disclosure, a reporting entity would have to demonstrate that it has undertaken a related party transaction on the same terms as current transactions with unrelated parties, with similar volumes, terms and conditions. In many cases, judgment is required to determine whether the transactions took place on similar terms and conditions as with unrelated parties because there may not be identical transactions where terms and conditions have been determined by the open market.
- .91 A related party transaction that is in the normal course of operations occurs within a normal business relationship and on terms and conditions that are similar to those of transactions with unrelated parties. In such cases, it is likely that the exchange amount would approximate fair value that would have been arrived on an arm's length basis.
- .92 When a related party transaction occurs in the normal course of operations, the exchange amount is representative of the economic reality of the transaction and is sufficiently reliable to be used for financial reporting purposes. Generally, an item exchanged in the normal course of operations by related parties is subsequently used within a normal operating cycle to provide goods and services.
- .93 Whether or not a transaction is in the normal course of operations is a question of fact. Determining whether or not a transaction is in the normal course of operations is a matter of judgment. The determination would consider, but is not limited to, the following factors:
- (a) the type and scope of operations;
  - (b) the operating policies;
  - (c) the nature of products and services;
  - (d) the frequency or regularity of transactions; and
  - (e) the purpose of the transaction (for example, the generation revenue).
- .94 Examples of transactions in the normal course of operations are the sale or purchase of an inventory item, and the provision or receipt of a recurring service including management and administrative services.
- .95 A related party transaction is presumed not to have been undertaken on the same terms as current transactions with unrelated parties when it is not of a type that is usually, frequently or regularly undertaken by the entity for its operations. The

transfer of assets that were not acquired for resale would be an example of a transaction not in the normal course of operations.

**Preliminary View 10**

Disclosure of information about transactions between related parties and the reporting entity is not required when the transactions occur within a normal supplier or a client/recipient relationship on terms and conditions no more or less favourable than those that it is reasonable to expect the entity would have adopted if dealing with that related party at arm's length in the same circumstances.

- .96 For the purposes of this Invitation to Comment, an exchange of goods or services between related parties that has not been given accounting recognition is a related party transaction. An explanation of the nature of such a transaction and the fact that no consideration has been received or paid is useful to explain the effect of the transaction on the reporting entity's financial position and performance.
- .97 A reporting entity would provide information about significant unrecognized related party transactions in sufficient detail to enable users of the entity's financial statements to understand the impact they have had on its operations, financial position and performance. The information would include their nature and either a qualitative or quantitative indication of their extent. Such information would be provided in notes or in supplementary schedules to the financial statements.

**Preliminary View 11**

A reporting entity would provide information about significant unrecognized related party transactions in sufficient detail to enable users of the entity's financial statements to understand the impact they have had on its operations, financial position and performance.

**Compensation of key management personnel**

- .98 A survey of authoritative standard setters indicates that, although most consistently define related party to include key management personnel, they are not consistent with respect to requirements for disclosure of information about management compensation arrangements with key management personnel or close members of the family of key management personnel.
- .99 IPSASB in IPSAS 20, *Related Party Disclosures*, and the IASB in IAS 24 *Related Party Disclosures*, both require the disclosure of information about certain transactions with key management personnel whether or not they have occurred on an arm's length basis consistent with the operating conditions that apply in respect of the entity. Such disclosures include the aggregate remuneration of key management personnel and the number of individuals,

determined on a full-time equivalent basis, receiving remuneration, shown separately for major classes of key management personnel and including a description of each class.

- .100 IPSAS 20 requires separate disclosure of remuneration of close members of the family of key management personnel. IPSAS 20 also requires disclosure of information about the amount of loans advanced and outstanding balance, as well as the terms and conditions of loans made to key management personnel or close members of the family of key management personnel.
- .101 These standard setters have concluded that information relating to management compensation is relevant to decisions made by users of financial statements when it represents a material amount. The structure and amount of compensation could be major drivers in the implementation of the business strategy. The benefit of this information to users of financial statements largely outweighs the potential lack of comparability arising from the absence of recognition and measurement requirements for all forms of compensation.
- .102 These standard setters have concluded that disclosing key management personnel compensation would improve transparency and comparability, thereby enabling users of financial statements to make a better assessment of the impact of such compensation on the entity's financial position and performance. An exemption of disclosure of key management personnel compensation “paid in the ordinary course of business” could lead to abuse. Establishing a disclosure exemption on such a criterion without a definition of the terms could lead to exempting other transactions with management from being disclosed, because they could all be structured as “compensation paid in the ordinary course of an entity's operations”.
- .103 Both the FASB in FAS 57, “Related Party Disclosures,” and the AcSB RELATED PARTY TRANSACTIONS, Sections 3840 and 4460<sup>5</sup> in Parts II and III of CICA Handbook – Accounting, respectively, do not require disclosure of compensation arrangements, expense allowances and similar payments to individuals in the normal course of operations. The FASB concludes that disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business is not necessary for a user to understand the financial statements.
- .104 Compensation arrangements of key management personnel in government entities are often established by statute, council bylaw or resolution or other governing body. The processes for approving compensation for key management

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<sup>5</sup> This Section establishes disclosure standards for related party transactions in the financial statements of not-for-profit organizations and has been carried forward by both the AcSB and PSAB intact to relevant Handbooks, effective for fiscal periods beginning on or after January 2012.

personnel usually involves other parties such as elected officials to ensure an arm's length result.

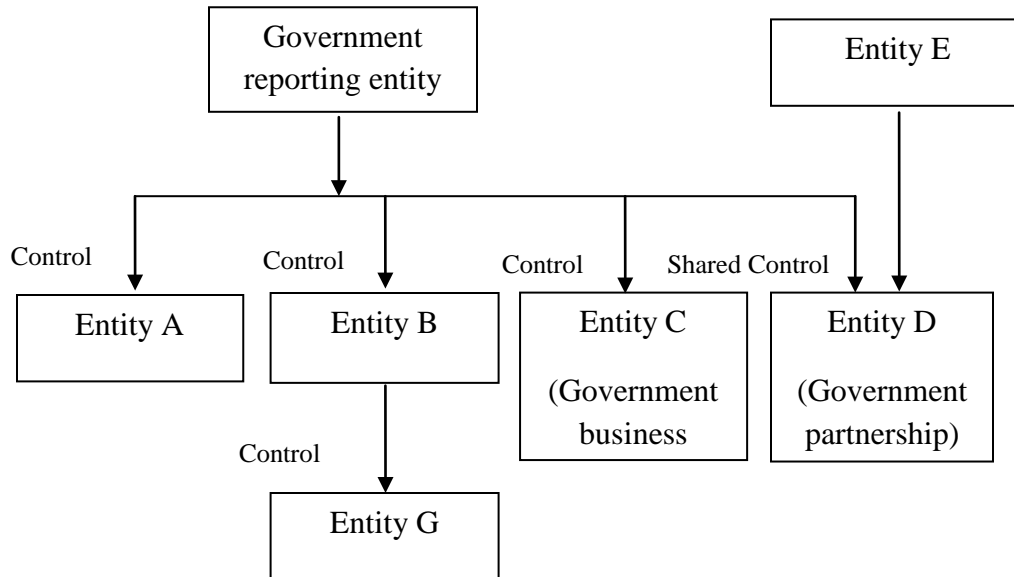
- .105 An argument has been made that most jurisdictions in Canada have established statutes and regulations applicable to public sector entities that require disclosure of information to the public about the amount of compensation a public sector entity pays or provides in the fiscal year or in the calendar year, directly or indirectly, to members of its governing body and its officers and employees. The legislation considers this information important because of the fiduciary responsibilities of elected and appointed officials and because they have extensive powers over the deployment of the economic resources of a public sector entity.
- .106 PSAB is of the view that, in the normal course of operations, disclosure of key management personnel compensation arrangements, including employee retirement benefits and other employee future benefits accounted for in accordance with RETIREMENT BENEFITS, Section PS 3250, and POST-EMPLOYMENT BENEFITS, COMPENSATED ABSENCES AND TERMINATION BENEFITS, Section PS 3255, expense allowances and other similar payments is not required.

**Preliminary View 12**

In the normal course of operations, disclosure of key management personnel compensation arrangements, expense allowances and other similar payments is not required in general purpose financial statements.

## APPENDIX

### IDENTIFICATION OF RELATED PARTIES



**Scenario A – Government reporting entity is the entity preparing general purpose financial statements.**

	<b>Explanation</b>	<b>Requirement to disclose Related Party Transactions</b>
<b>Related parties</b> Entities A, B, C, D and G	Entities are under the common control or shared control, directly or indirectly, of the government	No disclosures required for transactions between government and Entities A, B, D and G. The financial effects of inter-organizational transactions between A, B, D and G eliminated on consolidation.  No disclosures required for transactions between government and Entity C except as provided by INVESTMENTS IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070.
<b>Unrelated parties</b> Entities E	Entity E is not a related party simply by the fact that it shares control of the government partnership.	Not applicable

**Scenario B – Entity A is the entity preparing general purpose financial statements (reporting entity)**

	<b>Explanation</b>	<b>Requirement to disclose RPTs</b>
<b>Related parties</b> Entities A, B, C, D and G	Entities are under the common control or shared control, directly or indirectly, of the government	Disclose unless the transactions occur within a normal supplier or a client/recipient relationship.
<b>Unrelated parties</b> Entities E	Entity E is not a related party because it shares control of the government partnership.	Not applicable