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Disclosure of related party transactions and economic dependency; Issues paper (1980 December 10)

American Institute of Certified Public Accountants. Disclosure of Related Parties Task Force

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December 10, 1980

DRAFT STATEMENT OF
FINANCIAL ACCOUNTING STANDARDS

DISCLOSURE OF RELATED PARTY TRANSACTIONS
AND ECONOMIC DEPENDENCY

PREPARED BY
DISCLOSURE OF RELATED PARTIES TASK FORCE
ACCOUNTING STANDARDS DIVISION
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
AcSEC FILE 2436

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INTRODUCTION AND BACKGROUND INFORMATION

1. The Financial Accounting Standards Board (Board) has been requested by the American Institute of Certified Public Accountants (AICPA) to address the issue of disclosure of transactions between or among related parties. For many years, that issue and the issues of accounting for and measuring prices assigned or not assigned to transactions between or among related parties have been addressed by various accounting standards setting bodies, but no accounting standard has been issued by the Board on the subjects. The propriety of prices assigned to related party transactions and the propriety of their terms often are matters of subjective judgment.

2. Narrow references to transactions with related parties appear or are implied in several places in authoritative accounting literature (see Appendix A). Current authoritative accounting literature does not address fully the majority of related party transactions.

3. In contrast, related party transactions are addressed in authoritative auditing literature, in Statement on Auditing Standards No. 6, "Related Party Transactions" (SAS No. 6), and in the Auditing Interpretations of SAS 6 issued by the staff of the AICPA auditing standards division as guidance on the application of that statement. SAS No. 6 provides guidance on auditing procedures and financial statement disclosures. Authoritative auditing literature, however, is intended to direct the activities of auditors, not of reporting enterprises. Further, SAS No. 6 is not a consideration for financial statements with which no auditor is associated.

4. Related party transactions also are mentioned in several AICPA Accounting and Audit Guides (Guides) and Statements of Position (SOPs), and in various rules and regulations of the Securities and Exchange Commission (SEC). The Guides and SOPs do not have the authority of Board pronouncements¹, and the SEC's rules and regulations apply only to financial statements of SEC registrants.

5. Economic dependency also is addressed in SAS 6, and that portion of SAS 6 is incorporated in paragraph 9 and footnote 2 of FASB Statement No. 21, "Suspension of the Reporting of Earnings Per Share and Segment Information by Nonpublic Enterprises."

6. Transactions between and among related parties are common, particularly between a parent and its subsidiaries and between closely held enterprises and their related parties. Because the propriety of prices assigned to related party transactions and the propriety of their terms are often highly subjective, this Statement does not address those matters. The Board concludes, however, that an enterprise should disclose information about related party transactions in its financial statements.

7. The Board also concludes that an enterprise should disclose information about economic dependency in its financial statements.

8. This Statement supersedes paragraph 9 and footnote 2 of FASB Statement No. 21.

¹ See FASB Statement No. 32, "Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters."

9. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date specified in paragraph 14 is advisable in the circumstances.

STANDARD OF FINANCIAL ACCOUNTING AND REPORTING

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

- a. Related parties. The reporting entity; its affiliates; principal owners of the reporting entity; its management, and members of the immediate families of principal owners of the reporting entity and its management; entities for which investments are accounted for by the equity method by the reporting entity; and other parties with which the reporting entity may deal if one party can influence significantly the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its separate interests. Another entity is also a related party if it can influence significantly the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can influence significantly the

other to an extent that one or more of the transacting parties might be prevented from fully pursuing its separate interests.

- b. Affiliate. A party that directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, a specified party.
- c. Control. The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a specified party through ownership, by contract, or otherwise.
- d. Principal owners. The owners of record or known beneficial owners of more than 10% of the voting interests of the reporting entity.
- e. Management. Persons who are responsible for achieving the objectives of the organization and who have the authority to establish policies by which such objectives are to be pursued. Management normally includes members of the board of directors, the president, secretary, treasurer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions.

- f. Immediate family. Family members whom a principal owner or a member of management might control or influence or by whom they may be controlled or influenced because of the family relationship. The immediate family of an individual normally includes his or her spouse as well as their parents, children, brothers and sisters and their spouses, including adoptive and step relationships, and other persons who live in the households of one or more members of the family.
- g. Related party transactions. Transactions between or among related parties. Examples of related party transactions include transactions between a parent company and its subsidiaries, transactions between or among subsidiaries of a common parent, and transactions in which the reporting entity participates with other affiliated businesses, with management or with principal stockholders (or other ownership interests). Transactions between or among the foregoing parties are considered to be related party transactions even though they may not be given accounting recognition. Related party transactions may not now be recognized in accounting.

For example, an entity may provide services to a related party without charge; the related party may not record receipt of the services.

11. Financial statements shall include information describing related party transactions, other than compensation arrangements for personal services, expense allowances, and other similar items that are in the ordinary course of business.² Monetary or nonmonetary contributions made to nonprofit organizations by their officers, board members, or employees, however, need not be disclosed as related party transactions if the contributors received no reciprocal economic benefits from the nonprofit organizations.

² If a set of financial statements that purport to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles is presented for a parent company, a subsidiary, a corporate joint venture, or a 50-percent-or-less-owned investee, each of those entities or a combined group of those entities is considered for the purposes of this Statement to be an enterprise and is subject to the requirements of this Statement if those financial statements are issued separately. However, information that otherwise would be required to be disclosed by this Statement need not be disclosed in a set of financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

12. The disclosure shall include
 - a. The nature of the relationships³
 - b. A description of the transactions,⁴ including transactions to which no amounts or nominal amounts were ascribed, summarized if appropriate, for the periods presented, including amounts⁵ and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
 - c. The dollar amount of transactions and the effects of a change, if any, in the method of establishing terms from that used in the preceding period.

³ If necessary to an understanding of the relationship, the name of the related party shall be disclosed.

⁴ Appendix B gives examples of types of transactions to which this Statement applies.

⁵ By definition, the price assigned to a transaction between related parties cannot be a free market price as the requisite conditions of competitive, free market dealings do not exist. Accordingly, if equivalency representations are made, they should be restricted to statements that the related party transactions were at prices and terms equivalent to those available to and transacted with unrelated parties and should not state that the transactions took place at free market prices or on an arms length basis.

d. Amounts due from or to related parties and, if not otherwise apparent, the terms and manner of settlement.

13. An entity may be economically dependent on one or more parties with which it transacts a significant volume of business, such as a sole or major customer, supplier, franchisor, franchisee, distributor, general agent, borrower, or lender, which may be related parties as defined in this statement. However, such parties should not be considered related parties solely by virtue of economic dependency unless one of them clearly exercises significant management or ownership influence over the other. An enterprise that is economically dependent on another, regardless of whether the enterprises are related parties, shall disclose in its financial statements the nature of the dependence.

EFFECTIVE DATE AND TRANSITION

14. This Statement shall be effective on issuance.

<p>The provisions of this Statement need not be applied to immaterial items.</p>
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APPENDIX A

15. References to related parties or transactions appear in or are implied in the following authoritative accounting literature.

- Accounting Research Bulletin No. 43, Chapter 1A, paragraph 5, states that "Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivables or accounts receivable."
- Accounting Research Bulletin No. 51, paragraphs 21 and 22, indicates that there are circumstances in which combined financial statements of commonly controlled companies are likely to be more meaningful than their separate statements.
- APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock."
- APB Opinion No. 21, "Interest on Receivables and Payables," paragraph 3, indicates that the Opinion does not apply to transactions between parent and subsidiary companies and between subsidiaries of a common parent.
- APB Opinion No. 26, "Early Extinguishment of Debt," footnote 1, indicates that transactions between related parties may in essence be capital transactions.

- FASB Statement No. 13, "Accounting for Leases," paragraphs 5(a), 20, and 29 to 31, define and include special provisions on related parties in accounting for leasing transactions.
- FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise," paragraphs 8 and 23 as amended, require disclosure of information about intersegment sales and transfer prices.
- FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructuring," paragraph 42, discusses debt restructuring when debtor control changes.

16. Rule 4-08(k) of Regulation S-X, as amended, effective for fiscal years ended after December 15, 1980, includes requirements similar to those set forth in paragraph 12 of this Statement.

APPENDIX B

17. This Appendix gives examples of types of transactions between or among related parties to which the requirements of this Statement apply. The examples are not all inclusive.

- Sales, purchases, and transfers of realty, personalty, and services.
- Services received or furnished, for example, accounting, management, engineering, and legal services.
- Use of property and equipment by lease or otherwise.
- Borrowings and lendings.
- Guarantees
- Use by one of the related parties of bank balances as compensating balances for the benefit of another.
- Intercompany billings based on allocations of common costs.
- Filings of consolidated tax returns and intercompany billings based on allocations (including the method of allocation) or non-allocations of the amount of income tax paid and income tax expense.