

1 Related parties under FRS 102 refresher (Lecture A663 – 15.05 minutes)

It is fair to say that related parties have long-since been a contentious issue and, unfortunately, it seems that this is also the case under FRS 102 as well. Care needs to be taken with related party disclosures because they can be problematic and it is important, therefore, that a sound understanding of FRS 102, Section 33 *Related Party Disclosures* and the requirements of Section 1A *Small Entities* at paragraphs 1AC.34 to 1AC.36 (which deals with related party issues for small entities) is grasped.

At the outset it is worth noting that if a small entity has an audit, the auditor must not ignore the disclosure requirements of Section 1A. There are specific disclosures which may need to be made in the financial statements – for example, if a related party transaction has not been concluded under normal market conditions. Auditors must not assume that just because the entity is disclosing information in accordance with Section 1A that related party issues can be ignored because this can increase audit risk (the risk that the auditor expresses an incorrect opinion on the financial statements). Keep in mind that the Companies Act 2006 states that disclosure of transactions which the company has entered into with related parties **must** be given where such transactions are material and have not been concluded under normal market conditions. This is reflected in FRS 102, para 1AC.35.

1.1 Identifying a related party

A related party can be an individual or a business entity (whether incorporated or a sole trader, a partnership or an LLP).

FRS 102, Section 33 distinguishes related parties between *persons* who may be related parties (para 33.2(a)) and *entities* who may be related parties (para 33.2(b)). FRS 102, para 3.2(a) says:

*'A person or a **close member of that person's family** is related to a reporting entity if that person:*

FRS 102, para 33.2

- (i) has **control** or **joint control** over the reporting entity;*
- (ii) has **significant influence** over the reporting entity; or*
- (iii) is a member of the **key management personnel** of the reporting entity or of a **parent** of the reporting entity.'*

Terms which are shown in **bold type** mean that they are defined terms in the Glossary.

It should be borne in mind that the term 'close member of that person's family' is not a test as to whether a close family member can influence, or be influenced by, that person in their dealings with the entity.

Instead, it is a test of whether the **users** of the financial statements would regard the close family members as having influence over that person. Keep in mind that the test is quite wide in its scope.

For the purpose of financial reporting, 'control' is usually obtained by virtue of an ownership interest of more than 50% of the voting rights of the entity. Numeric benchmarks are not, however, the only indicator that control exists and so regard must be had to the substance of the relationship (in some situations, control can be obtained even with an ownership interest of 50% or less).

'Significant influence' is usually obtained with an ownership interest of between 20 and 50%. As with control, numeric benchmarks are not always an indicator that significant influence exists – there may be other characteristics which could indicate an individual may have the ability to exert significant influence over the business despite having an ownership interest of less than 20%.

The term 'key management personnel' is also wide in scope. It is not confined to just the directors of a reporting entity. Managers and supervisors could, for example, be regarded as key management personnel if they have any authority or responsibility for planning, directing and controlling the activities of the entity (either directly or indirectly). Key management personnel may also include directors of subsidiaries who are not on the board of the group.

Entities who are related parties of the reporting entity

FRS 102, para 33.2(b) then outlines the conditions which would give rise to an entity being related to a reporting entity. These conditions are as follows:

- (i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).*
- (ii) one entity is an **associate** or **joint venture** of the other entity (or an associate or joint venture of a member of a group of which the other is a member).*
- (iii) both entities are joint ventures of the same party.*
- (iv) one entity is a joint venture of a third party and the other entity is an associate of the third party.*
- (v) the entity is a **post-employment benefit plan** for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.*
- (vi) the entity is controlled or jointly controlled by a person identified in (a).*

*FRS 102, para
33.2(b)*

- (vii) *a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).*
- (viii) *the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.'*

As noted above, and as outlined in FRS 102, para 33.3, it is important that when considering each possible related party relationship, the entity must assess the **substance** of the relationship rather than the legal form. This would also apply to small companies as well (even those reporting under FRS 102, Section 1A).

1.2 Entities who are not classed as related parties

FRS 102, para 33.4 states:

'In the context of this FRS, the following are not related parties:

FRS 102, para 33.4

- (a) *Two entities simply because they have a director or other key member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.*
- (b) *Two **venturers** because they share joint control over a joint venture.*
- (c) *Any of the following simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process):*
 - (i) *providers of finance;*
 - (ii) *trade unions;*
 - (iii) *public utilities; and*
 - (iv) *government departments and agencies.*
- (d) *A customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of **business**, merely by virtue of the resulting economic dependence.'*

Example – One director in common

Kerry is the sole director of Spring Ltd and Summer Ltd. During the year to 31 May 2019, Spring sold goods to Summer for £10,000 plus VAT.

Under FRS 102, Section 33, two companies are not related just because they have a director in common. More often than not, a director can have influence over the running of the company, but this does not necessarily give rise to Spring and Summer becoming related parties as both companies would be expected to go about their own business for the benefit of their respective shareholders.

Example – Security pledged for borrowings

The facts are the same as above, but now consider a situation where Spring Ltd has pledged security for Summer's borrowings. This would mean that Spring has put Summer's interests before its own and in this case both entities would become related parties for the entire accounting period.

1.3 Intra-group trading

FRS 102, para 33.1A clarifies that transactions entered into between two or more members of a group need not be made in the financial statements provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

Example – Intra-group trading

The following illustrates the structure of the Autumn Group Ltd:



During the year to 31 March 2019 all three entities trade with each other.

Winter Limited is a wholly owned subsidiary of Autumn Ltd. Winter Ltd also has control over Solstice Ltd because it owns more than 50% of the subsidiary. However, Solstice Ltd is not a wholly owned group member and hence transactions with Solstice Ltd would be disclosed within Autumn and Winter's individual financial statements.

If, however, Autumn Ltd owned the remaining 40% of Solstice Ltd, then Solstice would become a wholly owned subsidiary within the group and all three companies would be able to take advantage of the exemption from disclosing all trading among themselves.

1.4 Examples of related party transactions

FRS 102, para 33.12 provides a useful list of examples of related party transactions which may need disclosure as follows:

- a) purchases or sales of goods (finished or unfinished);
- b) purchases or sales of property and other **assets**;
- c) rendering or receiving of services;
- d) leases;

FRS 102, para 33.12

- e) transfers of **research and development**;
- f) transfers under licence agreements;
- g) transfers under finance arrangements (including loans and equity contributions in **cash** or in kind);
- h) provision of guarantees or collateral;
- i) settlement of **liabilities** on behalf of the entity or by the entity on behalf of another party; and
- j) participation by a parent or subsidiary in a **defined benefit plan** that shares risks between group entities.

1.5 Disclosure requirements for non-small entities (FRS 102, Section 33)

It should be noted at the outset that FRS 102 (both Section 33 and Section 1A) does not require the names of the transacting related parties to be disclosed. Instead, the standard requires the entity to disclose the **nature** of the related party relationship. This applies to both small and non-small entities. FRS 102, Section 33 requires the following to be disclosed:

Parent-subsidiary relationships

Relationships between a parent and a subsidiary are to be disclosed regardless of whether, or not, there have been any related party transactions as required by FRS 102, para 33.5.

The entity must disclose the name of its parent and, where different, the ultimate controlling party. When neither the parent nor the ultimate controlling party produce publicly available financial statements, the name of the next most senior parent that does so (if any) is to be disclosed.

Key management personnel compensation

Key management personnel compensation is consideration of all forms paid, or payable, to key management personnel (KMP) in exchange for services rendered. Please note, this is not the same as the directors' emoluments and other benefits disclosure which is required under company law. For the purposes of KMP compensation, it includes all employee benefits (e.g. salaries, benefits in kind, paid leave, profit-sharing and bonuses) including share-based payments which are dealt with in FRS 102, Section 26 *Share-based Payment*. It is the cost of the compensation to the entity and must be disclosed in totality for all members of KMP (names need not be given nor does it need to be disaggregated into remuneration, pension contributions etc).

There is an exemption in FRS 102 (March 2018) from disclosing KMP in totality. This can be applied when the entity is required by law or regulation to disclose directors' remuneration (or equivalent) and KMP and the directors are the same body. Keep in mind that KMP is not confined to just the directors – it can involve anyone with authority for planning, directing and controlling the entity, hence supervisors and managers who are not directors may be included in KMP. Therefore, there are a lot of entities which will be unable to apply the exemption in FRS 102, para 33.7A.

The exemption in FRS 102 (March 2018), para 33.7A was one of the amendments made by the FRC during their triennial review of the standard. It therefore applies to accounting periods commencing on or after 1 January 2019, but can be early adopted provided all the amendments arising from the triennial review are applied at the same time. The only two amendments which can be early adopted separately without having to early adopt all the amendments are the directors' loan and tax effects of gift aid payments amendments.

Related party transactions

Related party transactions do not have to have a price attached to them in order for them to need disclosure – they can be entered into at nil consideration and even such transactions are disclosable. When the entity has entered into related party transactions it must disclose the nature of the related party relationship and provide further information about the transactions, outstanding balances and commitments which are necessary for an understanding of the (potential) effects of the relationship on the financial statements. Keep in mind that this is the whole purpose of related party disclosures – to inform the user that the financial statements may have been affected by the existence of related parties and transactions and balances with those related parties.

As a minimum, the disclosures must include:

- '(a) The amount of the transactions.*
- (b) The amount of outstanding balances and:
 - (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and*
 - (ii) details of any guarantees given or received.**
- (c) Provisions for uncollectible receivables related to the amount of outstanding balances.*
- (d) The expense recognised during the period in respect of bad or doubtful debts due from related parties.'*

FRS 102, para 33.9

The above disclosures are the minimum required by FRS 102, Section 33. Other significant information must be disclosed if this is necessary for an understanding of the financial statements.

The above disclosures must be made for each of the following categories:

- ‘(a) entities with control, joint control or significant influence over the entity;*
- (b) entities over which the entity has control, joint control or significant influence;*
- (c) key management personnel of the entity or its parent (in the aggregate);*
- (d) entities that provide key management personnel services to the entity; and*
- (e) other related parties.’*

FRS 102, para 33.10

FRS 102, para 33.10 provides the minimum disaggregation but further disaggregation in addition to the above would be required by FRS 102, para 33.14 when such disaggregation is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

1.6 Arm’s length related party transactions

A reporting entity cannot assert in the financial statements that related party transactions were made on terms equivalent to those which prevail in an arm’s length transaction unless such terms can be substantiated. Auditors need to pay particular attention to this and ensure they obtain appropriate audit evidence where such a statement has been made in the financial statements.

FRS 102, para 33.13 prohibits entities from stating that transactions with related parties are carried out on terms equivalent to those prevailing in an arm’s length transaction when, in fact, they have not, because such a statement would clearly be misleading. The whole point of making related party disclosures is to highlight that the financial statements may have been influenced by the presence of related party transactions which may have not been carried out on an arm’s length basis.

1.7 Small entities (Section 1A)

As noted above, FRS 102, para 1AC.35 does not require the names of transacting related parties to be disclosed – instead it follows the principles in Section 33 and requires the nature of the related party relationship to be disclosed.

The Small Companies and Groups (Accounts and Directors’ Report) Regulations 2008 (SI 2008/409) state that an entity **may** disclose details of transactions which the company has entered into with related parties. However, both the

Act and Section 1A do specifically require disclosure of material transactions which have not been undertaken under normal market conditions with:

- (a) owners holding a participating interest in the company;
- (b) companies in which the company has a participating interest; and
- (c) the company's directors (or members of its governing body).

In respect of such transactions, the small entity must disclose:

- '(a) the amount of such transactions;
- (b) the nature of the related party relationship; and
- (c) other information about the transactions necessary for an understanding of the financial position of the small entity.'

*FRS 102, para
1AC.35*

When transactions have been entered into between related parties which are similar in nature, the entity may aggregate them. However, separate disclosure would be required when this is necessary for an understanding of the effects of the related party transactions on the financial position of the small entity.

Important point

The above disclosure requirements are the legally required minimum as per the Companies Act 2006. However, it must be borne in mind that directors of small entities have a legal duty to ensure the financial statements give a true and fair view and hence directors must consider whether additional related party disclosures need to be made in order to achieve this. Regard must be had to Section 33 of FRS 102 in case any additional disclosures may be necessary to achieve a true and fair view.

1.8 Audits of small entities

As noted earlier in this section of the notes, auditors of small entities cannot simply ignore related party disclosures because Section 1A has been applied in the preparation of the entity's financial statements. Indeed, some related party transactions may not have been disclosed by the directors either through oversight or deliberately. The auditor must therefore still gather all of the normal information about who the related parties are, as set out in ISA (UK) 550, as otherwise they will not be able to ascertain if there are any transactions that need disclosing or other impacts on the financial statements.

The auditor must then consider whether any such transactions have been concluded under normal market conditions because if they are material and have **not** been concluded under normal market conditions then they will be disclosable.

If the auditor does not consider these issues, there is a risk that they will express an incorrect opinion on the financial statements (e.g. expressing an unmodified opinion rather than a modified (e.g. qualified 'except for') opinion).

Under FRS 102, Section 1A, the majority of small entities are making much less in the way of disclosures where related parties are concerned. However, auditors must ensure they understand exactly what FRS 102, paras 1AC.34 to 1AC.36 require and the fact that additional disclosures may be disclosable where related parties are concerned in order to give a true and fair view. Remember, FRS 102 Section 1A is not absolutely conclusive in every respect – potentially anything in FRS 102 is disclosable for a small entity if doing so enables a true and fair view to be given. Professional judgement in these areas will be necessary.