

Inter-entity Transactions — Basis for Conclusions

Section PS 3420

Foreword

CPA Canada Public Sector Accounting Handbook Revisions Release No. 42, issued in March 2015, contained a new standard, INTER-ENTITY TRANSACTIONS, Section PS 3420.

The primary objective of a Basis for Conclusions document is to set out how the Public Sector Accounting Board (PSAB) reached its conclusions. As well, it sets out significant matters arising from comments received in response to the proposals exposed and indicates how PSAB has dealt with the issues raised.

These documents are intended to assist financial statement users, preparers, auditors and other parties interested in public sector financial reporting in understanding the rationale followed by PSAB when developing standards.

This document has been prepared by staff of PSAB. It does not form part of the CPA Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles (GAAP). Basis for Conclusions documents also do not include any guidance on the application of the relevant Section or Guideline.

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BACKGROUND

- 1 PSAB initiated a project because the CPA Canada Public Sector Accounting (PSA) Handbook did not have an overarching standard on related party transactions. Filling this gap was particularly important since many public sector entities were adopting public sector accounting standards that had previously followed the CPA Canada Handbook – Accounting. For example, government not-for-profit organizations that adopt the PSA Handbook without Sections PS 4200 to PS 4270 (the PS 4200 series) would find no guidance comparable to that which they had previously followed.
- 2 In the absence of a standard, a public sector entity would be required to develop accounting policies in accordance with GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150. PSAB concluded that there may be

negative implications for public sector entities in adopting other authoritative standards. Other authoritative standard setters have developed very broad definitions of a related party that could expand the relationships that would be disclosed. The objectives of other authoritative standard setters that drive the requirements in their standards may not be consistent with the objectives of public sector financial statements. For example, others may place a high emphasis on disclosure of transactions with key management personnel and their close family members including, in some cases, compensation arrangements. Other authoritative standard setters may have different thresholds when assessing reportable related party transactions. Given the nature of the relationship, a transaction may be material regardless of its size. Other authoritative standard setters may require the measurement of related party transactions.

- 3 The purpose of the project was to develop a standard that would apply to public sector entities that, for purposes of their financial reporting, adhere to the standards for governments in the PSA Handbook. It would:
 - (a) define a related party;
 - (b) establish criteria for identifying related parties from the perspective of the entity that is reporting;
 - (c) identify the circumstances in which disclosure of transactions between the entity that is reporting and its related parties is required and
 - (d) set out disclosure requirements.
- 4 As part of the project, PSAB considered the need and advisability of establishing recognition and measurement standards for related party transactions of governments and government organizations. Issues of recognition and measurement generally arise when related party transactions occur between entities that are part of the same reporting entity. A variety of reporting practices regarding the recognition and measurement of related party transactions exist among public sector entities. Some consistency in practices would make financial statements more comparable and understandable for users.
- 5 In October 2011, PSAB issued an Invitation to Comment to seek feedback on a proposed standard for the disclosure of information about transactions between an entity preparing financial statements and its related parties. Concurrently, an Issues Paper was issued seeking views on the need for the inclusion of standards that should be applied in recognition and measurement of related party transactions.
- 6 Respondents, although raising issues with specific proposals, were generally supportive of the definitions and disclosures proposed in the Invitation to Comment. As well, respondents generally supported inclusion of guidance on recognition and measurement. In September 2012, PSAB issued an exposure draft of a proposed new Section on related party transactions. The Exposure Draft took into account comments received on the Invitation to Comment and Issues Paper.
- 7 After deliberating the issues raised by respondents to the September 2012 Exposure Draft, PSAB concluded that the changes to the proposed standard were significant and required re-exposure. PSAB issued a re-exposure draft in June 2013.
- 8 After deliberating the issues raised by respondents to the June 2013 Re-Exposure Draft, PSAB again concluded that the changes to the proposed standard exposed were significant and required re-exposure. PSAB issued a re-exposure draft in April 2014.
- 9 **Separating the standards**
 - After considering the responses to its 2011 Issues Paper, PSAB concluded that a Section on related party transactions should include recognition and measurement guidance. The proposed guidance in the June 2013 Re-exposure Draft focused on recognition and measurement of transactions occurring between entities that are part of the same government reporting entity by referring to provider and recipient organizations.
- 10 This created a subtle issue within the standard. For example, related party transactions can include transactions between the reporting entity and individuals who are members of key management personnel and close members of their family. They could also include transactions with entities that are controlled by members of key management personnel or that have key management personnel in common. A related party may be a government partnership with one or more private sector partners. The government partnership may apply the standards in the CPA Canada Handbook – Accounting to account for related party transactions. Recognition and measurement standards in Section PS 3420 could potentially be in conflict with these other standards.
- 11 Generally, issues of recognition and measurement would not arise for those related party transactions between individuals and entities that are not part of the same government reporting entity. They would be recognized at the exchange amount according to their substance and individual accounting standards applied for reporting purposes. This may conflict with the proposed general principle that related party transactions, with certain exceptions, would be recognized at their carrying amount. Disclosures about these related party transactions would be sufficient for users to understand the effect of those transactions on an entity's financial position and changes in financial position.
- 12 In the April 2014 Re-exposure Draft, PSAB proposed to issue two new Sections on related party transactions. The first Section defines a related party and establishes disclosures required for related party transactions. The second Section deals specifically with how to account for and report transactions between entities controlled by the government and that comprise the government's reporting entity from both a provider and recipient perspective.
- 13 The majority of respondents to the April 2014 Re-exposure Draft agreed with the proposal to create two new Sections. Two respondents, while not disagreeing with separation, commented that it would be more useful, and the clarity and

consistency of application of the standard would be improved if all definitions as well as recognition and measurement and disclosure requirements were located in the same standard. Two other respondents disagreed because they had issues with the proposed scope of the recognition and measurement standard. The latter respondents argued that the standard should be applicable to all related party transactions, not just transactions between government components and organizations under the control of a government that are part of the same government reporting entity.

- 14 After deliberating the issues raised by respondents, PSAB remained of the view that, in general, other related party transactions would be recognized in accordance with the standards the related parties apply in the preparation of their financial statements. Additionally, requirements in a section on recognition and measurement of related party transactions may conflict with these other standards.
- 15 INTER-ENTITY TRANSACTIONS, Section PS 3420, incorporates the proposed guidance for inter-entity transactions in the April 2014 Re-exposure Draft, with a number of changes. The final standard also incorporates the major issues raised by respondents to the Issues Paper, Exposure Draft and June 2013 Re-exposure Draft.

NEED FOR A STANDARD

- 16 A few respondents commented that it is not necessary to provide guidance on recognition and measurement of inter-entity transactions beyond disclosure of the basis used to recognize a transaction. It was argued that inter-entity transactions should be recorded at the value determined by government policy or the related parties. Existing standards in the PSA Handbook adequately define how particular transactions should be measured, and can be applied to address the underlying substance and appropriate measurement of inter-entity transactions. It was pointed out that the only standard within Canadian generally accepted accounting principles that contains measurement guidance is RELATED PARTY TRANSACTIONS, Section 3840 in Part II of the CPA Canada Handbook – Accounting.
- 17 There was general agreement among respondents that the PSA Handbook should include recognition and measurement guidance for inter-entity transactions between government organizations under common control and that are part of the same government reporting entity. They commented that existing guidance in the PSA Handbook is focused on summary financial statements of the government reporting entity in which related party transactions and unrealized gains or losses are eliminated. It was felt that guidance would help address an increasing number of accounting issues resulting from the adoption of the PSA Handbook standards by government organizations that previously followed other standards.
- 18 PSAB is of the view that in the absence of standards, inter-entity transactions may be reported at whatever value is determined by the related parties unless there is a specific existing standard that stipulates how such transactions should be measured. For example, TANGIBLE CAPITAL ASSETS, Section PS 3150, requires the transfer of an asset be measured at fair value. If the PSA Handbook is silent on accounting for a transaction or event, GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150, would be referenced to develop an appropriate accounting policy. This may result in entities having to record transactions at fair value. For example, NON-MONETARY TRANSACTIONS, Section 3831 in Part II of the CPA Canada Handbook – Accounting requires non-monetary transactions to be measured, with some exceptions, at the more reliably measurable of the fair value of the asset given up and the fair value of the asset received.
- 19 Other standards would similarly require measurement at fair value. ACCOUNTING STANDARDS FOR NOT-FOR-PROFIT ORGANIZATIONS, CONTRIBUTIONS — REVENUE RECOGNITION, Section 4410 in Part III of the CPA Canada Handbook – Accounting and Section PS 4210, respectively, require contributions to be measured at fair value if fair value can be reasonably estimated. ACCOUNTING STANDARDS FOR NOT-FOR-PROFIT ORGANIZATIONS, CAPITAL ASSETS HELD BY NOT-FOR-PROFIT ORGANIZATIONS, Sections 4431 and PS 4230, respectively, state that for a contributed capital asset, cost is considered to be fair value at the date of contribution. As well, a capital asset purchased by a not-for-profit organization at substantially below fair value would also be recognized at its fair value with the difference between the consideration paid for the capital asset and fair value reported as a contribution.
- 20 PSAB is of the view that, while the PSA Handbook currently contains a number of standards that could be referenced to address measurement of transactions between related entities, to a large extent, they apply when a government reporting entity is preparing its own consolidated financial statements. They do not necessarily address recognition and measurement of inter-entity transactions in the financial statements of individual entities that are part of the same government reporting entity.

SCOPE

- 21 A common comment of respondents was that the scope should be extended to provide recognition and measurement guidance on transactions between all related parties identified in the proposed Section on related party disclosures. It was felt that the scope limitation may result in significant inconsistencies in the measurement of those other related party transactions affecting consistency of reporting and comparability in public sector entity financial statements.
- 22 PSAB has previously concluded that issues of recognition and measurement generally arise when related party transactions occur between entities that are part of the same government reporting entity. Other related party transactions would generally be recognized in accordance with applicable individual sections of the standards the related parties apply in the preparation of their financial statements. Additionally, if guidance is included for recognition and measurement of other related party transactions, it may conflict with these other standards.

- 23 Some respondents felt the scope should include measurement of transactions between entities under shared control as well as transactions between a government partnership and partners other than those related to accounting for the partners' investments in assets and their partnership interests. One respondent argued that accounting for appropriations should be specifically scoped out of the standard since these transactions are likely the main inter-entity transactions within the government reporting entity.
- 24 The definition of commonly controlled entities would indirectly include government partnerships when all the partners are government components and organizations that are controlled by the government that comprise the government's reporting entity. If the entity that is reporting, for purposes of preparing its general purpose financial statements, applies the standards for governments in the PSA Handbook, this Section would be applicable.
- 25 The scope excludes transactions between a partner and a government partnership that are within the scope of GOVERNMENT PARTNERSHIPS, Section PS 3060.
- 26 PSAB previously terminated a project on accounting for and reporting use of appropriations in the separate financial statements of government organizations. In terminating the project, PSAB concluded that, since the use of appropriations is generally a monetary transaction, FINANCIAL STATEMENT PRESENTATION, Section PS 1201, and GOVERNMENT TRANSFERS, Section PS 3410, provide relevant guidance for reporting purposes. As well, application of this Section would be appropriate.

Restructuring transactions

- 27 Restructuring transactions have been excluded from the scope of the Section. It was suggested that it would be helpful to describe what is meant by "restructuring transactions" pending finalization of a standard on this issue.
- 28 An Exposure Draft, "Restructuring Transactions," issued in August 2014, proposes standards on how to account for and report restructuring transactions by both transferors and recipients of assets and/or liabilities, together with related program or operating responsibilities. The Exposure Draft covers all restructuring transactions regardless of whether the entities involved are commonly controlled entities. PSAB is of the view that it is not necessary to define a restructuring transaction in Section PS 3420.

APRIL 2014 RE-EXPOSURE DRAFT

Commonly controlled entities

- 29 The definition has been updated to reflect changes to the Introduction to Public Sector Accounting Standards.
- Unallocated costs**
- 30 Three respondents felt that the concept of unallocated costs needed extensive clarification. A definition that is the reciprocal of the definition of allocated costs and recovery, including examples, has been included in Section PS 3420.
- Transactions in the normal course of operations**
- 31 Two respondents felt that there was inconsistency with the definition of a transaction in the normal course of operations and the matters to take into account when determining whether transactions are undertaken in the normal course of operations. These respondents also argued that the statement that transfers of assets and liabilities are typically not in the normal course of operations was not always true. For example, the sale of inventory may be in the normal course of operations. It was suggested that the Section contain examples of transactions similar to those in RELATED PARTY TRANSACTIONS, Section 3840.
- 32 The term "in the normal course of operations" was used to identify those inter-entity transactions when the exchange amount would be more representative of the economic substance of the transaction than the carrying amount. Respondents to previous documents for comment have expressed concern that the concept, while fairly well understood in the private sector, needed to be put into the context of public sector entities. It was argued that it was normal in the public sector that entities engage in transactions that would not take place between unrelated parties or would be subject to different terms and conditions.
- 33 Despite attempts to define the term in the context of the public sector, its use continues to be problematic. The term "in the normal course of operations" has been eliminated in Section PS 3420. PSAB is of the view that when inter-entity transactions involving the provision of a good or service occur on terms and conditions that it is reasonable to expect would be adopted if the entities were dealing at arm's length measurement at the exchange amount is warranted.
- 34 Although most inter-entity transactions involving the transfer of assets or liabilities would be non-monetary reallocations of economic resources or obligations, in rare circumstances, they may involve an exchange of consideration that approximates fair value of the underlying item(s). When the consideration is exchanged based on the fair value of an asset or liability, such a transaction would be on similar terms as would be expected in an arm's length transaction between unrelated parties. In these circumstances, using the exchange amount rather than the carrying amount would be more representative of the economic substance of the transaction.
- 35 Section PS 3420 requires that inter-entity transactions should be recorded at the exchange amount when they are undertaken on similar terms and conditions to those adopted if the entities were dealing at arm's length. The Section also includes examples of transactions that may be undertaken on similar terms and conditions to those that it is reasonable to expect would be adopted if the entities were dealing at arm's length.

Criteria for using fair value

- 36 Several respondents commented that the April 2014 Re-exposure Draft could be interpreted as frequently requiring fair value measurement of an asset transferred for no or nominal consideration. It was argued that when an asset is transferred, it would always be the case that the recipient's future cash flows or capacity to provide goods and services would change.
- 37 The April 2014 Re-exposure Draft proposed that, because these are non-monetary transactions, a "commercial substance" test similar to that used in RELATED PARTY TRANSACTIONS, Section 3840, may be applied to determining whether fair value would be more representative of the economic substance of the transaction (i.e., fair value may be used when the recipient's future cash flows or service potential is expected to change significantly as a result of the transaction). A significant change would be measured by comparing the expected future cash flows or service potential of the entity against that which existed prior to the transaction.
- 38 Respondents have previously commented that the criteria for using fair value is not objective and is subject to interpretation that may result in inconsistent reporting and affect the comparability of financial statements. They have also argued that it is not clear how future economic benefits or service potential should be measured, or what would constitute a significant change. Given the difficulty with defining a significant change in cash flows and service capacity, Section PS 3420 eliminates the criteria for when fair value would be used.

Gains and losses

- 39 Several respondents were concerned that the proposed Section did not provide guidance on the accounting treatment of the difference between the exchange amount and the carrying amount for an asset or liability transferred in the financial statements of the recipient entity. Section PS 3420 clarifies that when there is a difference between the exchange amount and the carrying amount of a transferred or exchanged asset or liability, a gain or loss should be reported in the statement of operations.

Determining the exchange amount

- 40 Several respondents argued that the guidance on how the exchange amount may be determined under cost allocation and recovery was redundant of the definition and potentially may create confusion. That guidance has been eliminated from Section PS 3420.

Disclosures

- 41 Four respondents felt that disclosures should include more than the nature of inter-entity transactions. They argued that disclosures should include the nature of the relationship with the related party involved, the type of inter-entity transactions that have been recognized, the amounts recognized classified by financial statement category, the basis of measurement used, the amounts outstanding attached to them and the types of inter-entity transactions for which no amount has been recognized.
- 42 Section PS 3420 states that inter-entity transactions are related party transactions. An entity should disclose information about inter-entity transactions in accordance with RELATED PARTY DISCLOSURES, Section PS 2200.

MEASUREMENT

- 43 In arriving at the standards on measurement of inter-entity transactions, PSAB considered arguments that an accounting standard should not drive operational decision-making with respect to how a government manages its activities, allocates costs, or charges for interdepartmental provision of goods and services. It also considered the comments by several respondents that presented a contrary argument that how governments are organized, accountability structures adopted or budgetary practices should not determine accounting standards.

Carrying amount

- 44 PSAB is of the view that when a transaction involving the transfer of an asset or liability or the provision of a good or service occurs between public sector entities that are under common control of the same government, the carrying amount should be retained as a substantive change in the consolidated interest in the item does not occur. A majority of respondents agreed that, as a rule, inter-entity transactions should be measured at the carrying amount. However, PSAB acknowledges that there may be circumstances when a change in the carrying amount is justified. The proposed Section allowed flexibility to accommodate these circumstances.
- 45 There was a concern that the terminology used in the definition of carrying amount would lead to the conclusion that the transfer of assets would be recognized at the net carrying amount. PSAB is of the view the definition provides that the carrying amount for a tangible capital asset may be recorded at cost and accumulated amortization or for other assets at cost and valuation allowances in order that the amounts attached to the item are retained.

Transferred assets and liabilities at nominal or no consideration

- 46 Inter-entity transactions would be recognized when they involve the transfer of an asset or liability between entities under common control in order that financial statements of the entity that is reporting provide an accounting of the assets that it controls or obligations that will result in future sacrifice of economic resources.
- 47 The April 2014 Re-exposure Draft proposed that transfers of assets for nominal or no consideration (contributed assets) should be recognized by both the provider and recipient. It also clarified that the provider would recognize the transaction at the carrying amount and the recipient would recognize the transactions at the carrying amount or fair value. Respondents commented that giving recipients the option of recognizing the transaction at fair value was viewed

as a way to allow remeasurement of assets. It was felt that this would lead to diverse application of the standard in practice or to a manipulation of the financial statements affecting consistency of reporting and comparability.

- 48 It was intended that the recipient would use the carrying amount when there is no change in the use of the asset. In such cases, there is no significant change in the consolidated interest in the item. The carrying amount is appropriate as it retains the amounts attached to the items transferred. This is similar to the concept in the proposed standard on restructuring transactions (i.e., that a transfer of assets and liabilities together with related program or operating responsibilities in a restructuring transaction does not result in a change in use and, therefore, the carrying amount is appropriate).
- 49 In other cases, it may be appropriate that the recipient recognize the transaction at fair value. For example, fair value may be a better reflection of the economic substance of an inter-entity transaction involving the transfer of an asset when it will be used by the recipient in commercial type operations with business-oriented objectives. These objectives may include the generation of a commercial return from the asset.
- 50 PSAB is of the view that there may be circumstances when a change in the carrying amount of an asset is justified. Section PS 3420 still allows the recipient to recognize a transfer of an asset or liability for nominal or no consideration at the carrying amount or fair value. The valuation requires the exercise of judgment. The determination would be based on an assessment of the information needs of users, the nature of operations as well as policy, budget practice and accountability structures. Although the option may affect consistency of reporting, disclosure of information about the transaction in accordance with RELATED PARTY DISCLOSURES, Section PS 2200, allows users to assess the effect that the transaction had on an entity's reported financial position and changes in it as well as make comparisons.

Unallocated costs

- 51 It is not unusual for a public sector entity to establish a policy that certain activities are undertaken by central organizations to support the activities of other departments and agencies. For example, one government department may provide accommodation for other departments and agencies without charge. The provider entity may have a policy of funding the expenses related to these common services through appropriations or other revenue sources and not allocating the costs to individual recipient organizations.
- 52 PSAB is of the view that unallocated costs of goods or services between entities under common control of the same government are inter-entity transactions. These transactions confer an economic benefit on the recipient. The issue that arises is the extent to which these types of inter-entity transactions are recognized in the separate financial statements of recipient entities. There was no clear consensus among respondents to the PSAB's 2011 Issues Paper on whether unallocated costs should be recognized in financial statements and, if so, how they should be reported.
- 53 Some commented that recognition of unallocated costs in the individual financial statements of recipient entities would reflect all significant resources consumed and ensure that full cost-of-service information is provided. A contrary argument was that a robust disclosure standard would address these issues without requiring recognition. There were comments that the decision as to which unallocated costs of goods and services should be recognized by the recipient depends on the context in which the public sector entity operates and is a policy decision of the government.
- 54 Often, the cost of goods and services is not allocated and recorded by recipient entities because of record-keeping and valuation difficulties. Additionally, the benefits expected to arise from recognizing unallocated costs or quantifying them in financial statements may not exceed the cost of doing so. Similarly, these transactions are consistent with normal operating relationships that may be established between entities under common control to achieve common objectives, and the different mechanisms that may be adopted for the delivery of services.
- 55 PSAB is of the view that, at a minimum, a reporting entity should disclose information about unallocated costs. It has the option, when those goods and services would otherwise have been purchased, to recognize a revenue and expense. The determination of whether unallocated costs should be disclosed or recognized would require the exercise of judgment based on an assessment of the information needs of users and taking into account the nature of operations.

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