

## **HKAS 24 (Revised) - Related Party Disclosures**

### **(Relevant to AAT Examination Paper 7: Financial Accounting)**

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#### **Introduction**

Since the existence of related parties may result in transactions being completed other than at an arm's length basis, it is necessary to disclose the existence of related parties, and the nature and extent of transactions between related parties. HKAS 24 (Revised) "Related Party Disclosures" is useful in identifying related party relationships and transactions, as well as in determining the disclosures required for these transactions.

#### **Identification of related parties**

A standard on related party disclosures is needed because users of financial statements are entitled to assume that transactions included therein have been concluded at an arm's length basis. HKAS 24 (Revised) defines a related party as "a person or entity that is related to the entity that is preparing its financial statements" and further explains the meaning of related party as follows:

- (a) A person or a close member of that person's family is related to a reporting entity if that person:
  - (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.
- (b) An entity is related to a reporting entity if any of the following conditions applies:
  - (i) The entity and the reporting entity are members of the same group.
  - (ii) One entity is an associate or joint venture of the other entity.
  - (iii) Both entities are joint ventures of the same third party.
  - (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  - (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.
  - (vi) The entity is controlled or jointly controlled by a person identified in (a).

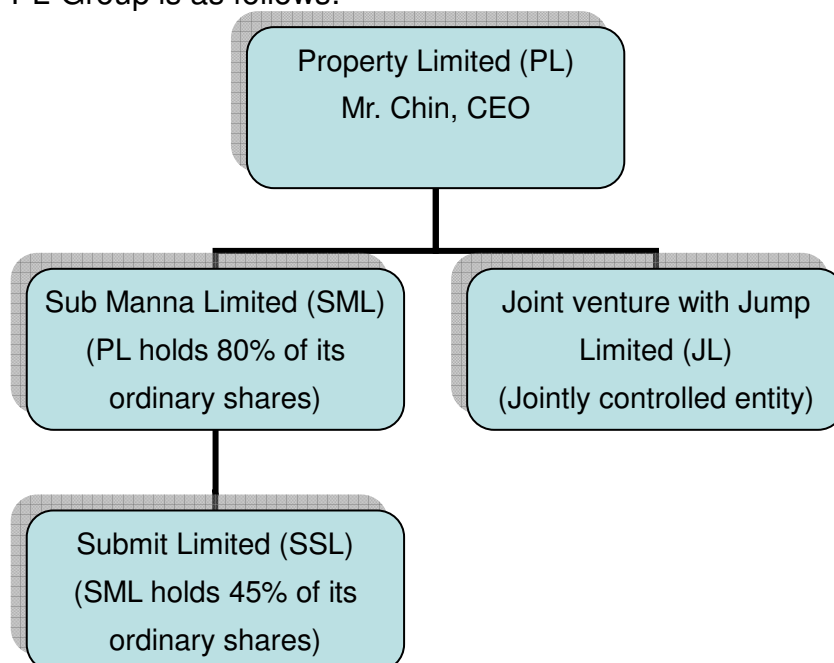
- (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity. Close members of a person's family may include: the person's domestic partner, spouse and children; children of the person's spouse or domestic partner; and dependants of the person or the person's domestic partner.

HKAS 24 (Revised) defines related party transaction as "a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged".

#### Example 1

Property Limited (PL), together with its subsidiaries as a group, is principally engaged in property development and property management. The structure of PL-Group is as follows:



The following information is also relevant:

- PL holds 20 percent of Asso Limited (AL)'s ordinary shares. Mr. Chin is the one of the four directors of AL. Each director has the same voting power regarding decisions on AL's financial and operating policy.
- Mrs. Chin, Mr. Chin's wife, works in SML as an assistant accountant.

Required:

Which entities are related parties of PL?

Solution:

- Mr. Chin is a related party because he is the CEO (i.e. a member of the key management personnel) of PL.
- SML is a related party because it is a subsidiary of PL; that is, PL can control SML's operating and financial policy.
- SSL is a related party because it is an associate of PL. PL owns a 36 percent (80 percent x 45 percent) interest in SSL and can have significant influence over SSL's financial and operating policy.
- JL is a related party because it is a joint venture of PL.
- AL may be a related party because the two companies, AL and PL, are under the common control of Mr. Chin. Two companies which have a director in common would not be treated as related parties unless it could be shown that the director is able to influence the policies of both companies in their mutual agreements.
- Mrs. Chin may be a related party because she is a family member of Mr. Chin, who is the CEO of PL. This falls within the definition of close family of a related party of PL. Close family, under HKAS 24 (Revised), refers to those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. Mrs. Chin is not a related party if it can be demonstrated that she does not influence the policies of PL.

**Significance of disclosing related party relationship and transactions**

A related party relationship can affect the financial position and performance of an entity under different circumstances:

- (a) Transactions may be entered into with a related party on terms different from those with an unrelated party. For example, transactions between related parties may take place at a different amount than if the parties were unrelated.
- (b) The existence of a related party relationship may affect transactions with third parties. For example, when two entities, A and B, are under the common control of P, the parent company, then P can instruct A to purchase goods from B instead of from other suppliers.
- (c) A transaction undertaken by the entity with other parties may be affected because of the significant influence of a related party. For example, a subsidiary may be instructed by its parent not to compete with the parent in certain lines of business.

### Example 2

Following the information in Example 1, Mr. Chin would like to sell SSL and wants to improve the price. The following transactions have occurred in PL-Group:

- (a) AL is instructed by PL to sell goods to SSL at low prices.
- (b) SML is instructed by PL to lease equipment to SSL at a below market price for similar leases.

### Required:

Discuss why it is important to disclose the related party relationship and the transactions between the related parties.

### Solution:

Without proper disclosure, it is possible that users may be misled when related party transactions are included in a SSL's financial statements. This is because related parties may enter into transactions that unrelated parties would not enter. In this case:

- AL sells goods to SSL at a price that might be different from the price it would get when selling to other customers. SSL makes a larger profit when the goods purchased from AL are sold to outsiders; however, these transactions between AL and SSL are not at arm's length.
- SML leases equipment to SSL at a price which is much lower than the market, inflating SSL's profit.

### **Disclosure requirements for related party transactions**

Once a related party relationship has been established and related party transactions have been identified, the question of what information to disclose arises. HKAS 24 (Revised) requires the disclosure of:

- (a) Control
  - the related party relationship, where the reporting entity is controlled by another party
- (b) Key management personnel compensation
  - short-term employee benefits,
  - post-employment and other long-term benefits,
  - termination benefits, and
  - equity compensation benefits
- (c) Transactions and balances between related parties
  - nature of the related party relationships,
  - types of transactions, and

- outstanding balances and commitments, including allowances for doubtful debts and bad debt

### Example 3

Following the information in Example 1, PL-Group has various joint venture projects with Mr. Chin and SML and all these transactions are on normal commercial terms. The following information is also available:

- Guarantees provided by PL and SML for a bank loan utilized by JL are \$40 million and \$400 million, respectively.
- The amount due to SSL at the year end is \$20 million.
- The amount due from JL at the year end is \$15 million.

### Disclosures:

#### Related party transactions

During the year and in the ordinary course of business, the Group undertook various joint venture projects with related parties, including the CEO, Mr. Chin, and SML, on normal commercial terms.

Advances made by the Group at the end of the reporting period were disclosed as amounts due to/from associates and jointly controlled entities in notes (1) and (2). Guarantees provided by the Group for bank loans utilized by jointly controlled entities at end of the reporting period were disclosed in note (3).

Other than the aforementioned, there were no other significant related party transactions requiring disclosure in the financial statements.

#### (1) Associates

Amount due to associates	\$20 million
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#### (2) Jointly Controlled Entities

Amount due from jointly controlled entities	\$15 million
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#### (3) Contingent Liabilities

The Company provided guarantees for bank loan financing utilized by joint controlled entities	\$40 million
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A subsidiary provided guarantees for bank loan financing utilized by joint controlled entities	\$400 million
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### **Conclusion**

The steps involved in determining the disclosures required under HKAS 24 (Revised) are:

- identify the existence of related parties;
- determine whether there are transactions between the reporting entity and its related parties;

- determine whether there are any loans and other outstanding balances or commitments between the reporting entity and its related parties;
- consider whether an adjustment is required to rectify any distortion of financial performance and financial position of the reporting entity;
- determine the information to be disclosed, under the circumstances given.