ACCOUNTING

CONTINUING EDUCATION

Related Party Transactions—A Recurring Issue

(RPT2)

KAPLAN

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KAPLAN

RELATED PARTY TRANSACTIONS—A RECURRING ISSUE (RPT2)
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TABLE OF CONTENTS

Learning Objectives.. 1

Introduction.. 1

Accounting Considerations 3

Discussion Question 11

ASU 2015-02, Consolidation (ASC Topic 810) Amendments to the Consolidation Analysis...................... 12

ASU 2016-17, Consolidation (Topic 810) Interest Held Through Related Parties That Are Under Common Control 17

ASU 2018-17, Consolidation (ASC Topic 810) Targeted Improvements to Related Party Guidance for Variable Interest Entities 19

Auditing Considerations.. 43

AICPA Practice Aid – Accounting and Auditing for Related Parties and Related Party Transactions........... 51

Conclusion.. 52

Appendix A.. 53

Appendix B 60

LEARNING OBJECTIVES

- **Identify** the importance of related party relationships, transactions, and disclosures to the fair presentation of financial statements
- **Identify** and **illustrate** the accounting guidance associated with related party transactions and disclosures
- **Provide** an update to consolidation guidance on interests held through related parties under common control
- **Illustrate** selected related party disclosures
- **Identify** and **illustrate** auditing guidance associated with auditing related party transactions

INTRODUCTION

In recent years, related parties, related party transactions, related party disclosures, and the auditing/reviewing/compiling of related party activity has received increased attention due to the publicity surrounding related party frauds and increases in transactions being processed electronically and the difficulty in identifying the source of many of these transactions. Additionally, related party accounting and disclosure issues are not often identified as being of significant risk and as a result, attention to the substance of these transactions is often limited to inquiry results rather than objective evidence.

Related party frauds such as Baptist Foundation of Arizona, Adelphia Communications, Rite Aid, Boston Scientific, American International Group (AIG), Lernout & Hauspie, and Parmalat SpA, also suggest that auditors are not paying enough attention to transactions involving related parties and to the possibility of undisclosed related parties.

EXAMPLE

Baptist Foundation of Arizona:

The Foundation sold promissory notes to individuals and churches guaranteeing the buyers high yields while at the same time claiming to improve the religious and social fabric of society. The Foundation was heavily invested in real estate when the real estate market in the Southwest crashed. Rather than take write downs, the Foundation sold many of the properties at inflated prices to related parties controlled by the management of the Foundation. The Foundation recorded inflated receivables from these related parties and reported substantial gains from these transactions.

The Foundation filed for bankruptcy in 1999 and investors lost over $1 billion due to the related party fraud. The related parties were concealed by the Foundation for 15 years and were never discovered by the outside auditor, Arthur Andersen, even after the fraudulent transactions were brought to AA’s attention by disgruntled ex-Foundation employees.

EXAMPLE

Adelphia Communications:

Adelphia was the sixth largest cable television company in the country. Management borrowed $3 billion from Adelphia for personal purposes without disclosing the borrowings. Part of the money was used to buy Adelphia stock in the open market to increase the ownership percentage of the Rigas family, who controlled management and the board. In addition, office supplies and related equipment were required to be purchased from a company owned by the wife of the president. Adelphia's auditors, Deloitte & Touche, denied any knowledge of these activities and stated that Deloitte was deceived as to the true nature of these transactions.

Because related party transactions are never at arms-length, these transactions for goods and services are priced at less or more favorable terms than arms-length transactions between unrelated parties.

Thus, when related parties exist, a reporting entity's results of operations and financial position may not reflect the economic environment in which the reporting entity operates. In turn, related parties create greater risk for lenders and investors.

Accounting and auditing literature has been updated to address some of the complex issues surrounding related parties and related party transactions and disclosures. This program reviews the accounting and auditing literature addressing related parties. The primary sources for information on related parties can be found in:

- FASB – ASC Topic 850, *Related Party Disclosures*
- FASB – ASC Topic 810, *Consolidation*
- IASB – IAS 24, *Related Party Disclosures*
- SEC – Item 404, *Certain Relationships and Related Transactions*
- PCAOB – AS 18, *Related Parties*
- ASB and IAASB – AU-C/ISA Section 550, *Related Parties*
- AICPA – *Accounting and Auditing for Related Parties and Related Party Transactions*

ACCOUNTING CONSIDERATIONS

Introduction

Related party accounting can primarily be found in four documents:

1. FASB's ASC Topic 850, *Related Party Disclosures*
2. FASB's ASC Topic 810, *Consolidation*
3. IASB's IAS 24, *Related Party Disclosures*
4. SEC's Item 404, *Certain Relationships and Related Transactions*

Related Party Definition

In general, a related party can be defined as a business or personal arrangement between two parties (entities and/or individuals) who have a prior/existing relationship that can result in preferential benefits for one or both of the parties.

ASC Topic 850 indicates that related parties include:

- Affiliates of the entity
- Entities for which investments in their equity securities would be required to be accounted for by the equity method by the investing entity
- Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- Principal owners of the entity and members of their immediate families
- Management of the entity and members of their immediate families
- Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

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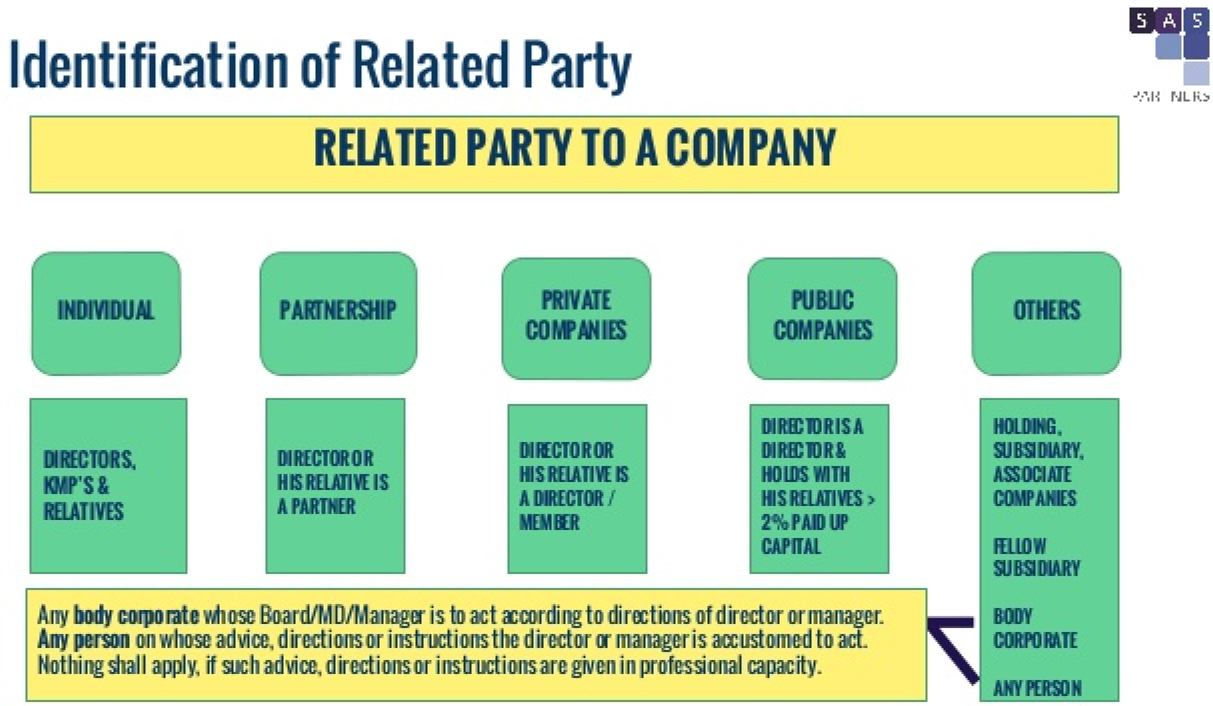
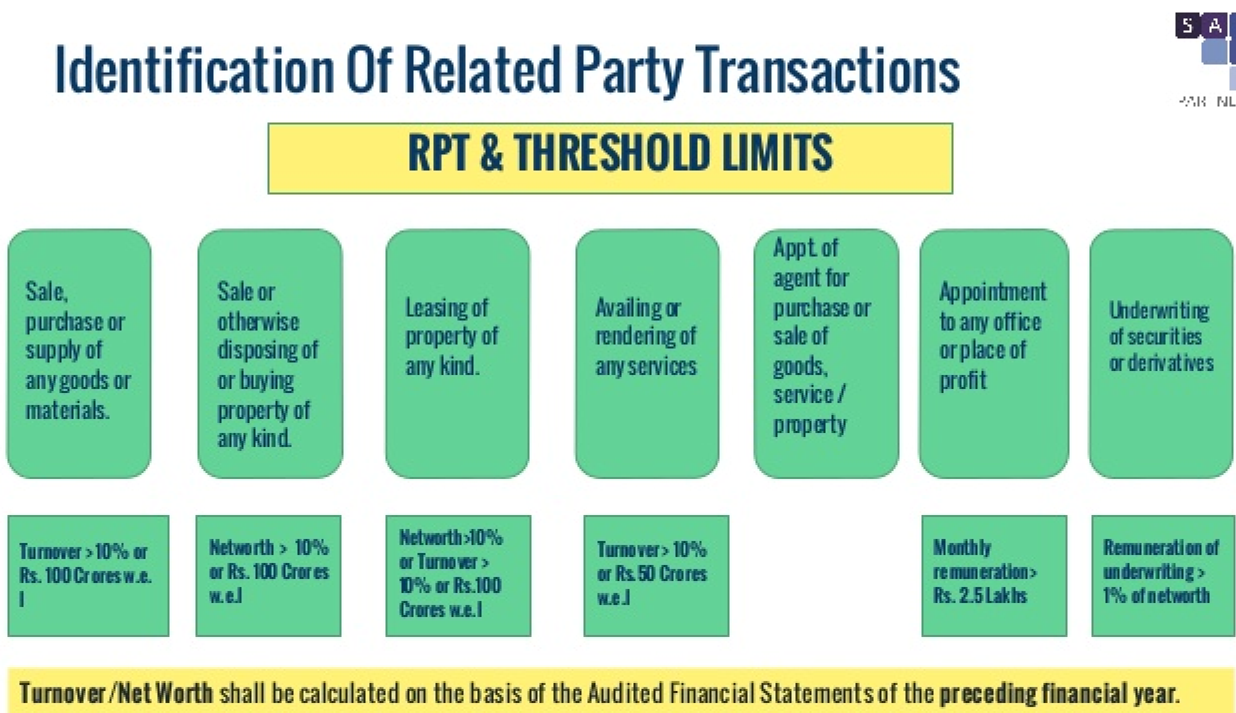




ASC Topic 850, Related Party Disclosures

According to ASC Topic 850, transactions between related parties commonly occur in the normal course of business. Examples of common transactions with related parties are:

- Sales, purchases, and transfers of real and personal property
- Services received or furnished, such as accounting, management, engineering, and legal services
- Use of property and equipment by lease or otherwise
- Borrowings, lending, and guarantees
- Maintenance of compensating bank balances for the benefit of a related party
- Intraentity billings based on allocations of common costs
- Filings of consolidated tax returns

If a reporting entity has material transactions with related parties, other than compensation arrangements, expense accounts, or transactions in the normal course of business with management or employees, **ASC Topic 850 requires the following extensive disclosures:**

1. **Nature of the relationships**, i.e., which of the above related parties are counterparties to the transactions. Terms such as *officer, stockholder, affiliate, parent company, or subsidiary* can be used.

2. **Description of the transactions**, such as purchases or sales, management fees, rents, cash advances, etc. The disclosure should describe the nature of the transactions and any information needed to understand what the effect is on a financial statement. This is also required even if no dollar amount was prescribed to the transaction.

3. **Dollar amounts of the transactions during each period presented.** This element is often missing. It means that, in addition to disclosing balances due at the balance sheet date, the amount of activity during the year should be quantified.

4. **Changes in the terms of transactions from year to year, if applicable.** If any terms have changed between the parties, for example, if scheduled repayment of a related party receivable was changed from $20,000 per year to $5,000 per year, disclosure would be required to clarify the effect on comparability.

5. **The receivable or payable balances at the balance sheet date.** ASC Topic 850 requires separate presentation of receivables from officers, employees, and affiliates on the face of the balance sheet. Therefore, receivables balances are "automatically" disclosed. Because of common practice, payables are treated the same as receivables.

6. **Settlement terms for receivables or payables, if not obvious.** This requirement can be a challenge when transactions are structured informally. Sometimes, the only possible disclosure may be to state that there are no formal terms for repayment.

7. **Nature of control relationships**, even when no transactions have occurred, if the relationships could significantly impact the company. This is especially relevant when no transactions have been recorded, despite economic dealings between related entities.

Other Considerations

ASC Section 850-10-50-6 emphasizes that "if the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities".

EXAMPLE

Two affiliated companies have an overlapping product line – the owners may decide that only one would fulfill customer orders because its location is more central, thereby reducing shipping costs. While there is no intercompany transaction, this decision does affect the financials of each affiliate that would not have occurred if they had not been related parties.

Also note that, in addition to disclosure required specifically for related parties, all other GAAP disclosures for leases, commitments, guarantees, long-term debt, etc., apply to related party transactions.

Although related party disclosures are applicable to **material** transactions, much care should be exercised in deciding what is material. A different materiality concept applies for related parties; unless an isolated, clearly insignificant transaction is involved, disclosure is normally appropriate. Consider, for example, the company that provides administrative support to an affiliate at no charge. While the recorded amount is zero, the situation is obviously not immaterial.

Unless it can be clearly supported and substantiated, related party disclosures should not include statements that imply the transactions were made at "arms-length." In addition, disclosure to the contrary (i.e., NOT at arms-length) does not need to be made. So long as the actual terms are described, the disclosure requirements are met. Care should be taken when using the terms "at market" for these disclosures.

The following example footnote illustrates straightforward application of ASC Topic 850 disclosure requirements.

EXAMPLE

Note 5: Related Party Transactions

The Company leases its facilities from an entity related through common ownership on a month-to-month basis. Rent expense was $56,000 in 20X7 and $52,000 in 20X6.

The Company provides administrative services at no charge to an affiliate related through common ownership. Such services include office and sales support staff, as well as use of equipment and vehicles.

Loans receivable from officer bear interest at 8% and result from cash advances of $40,000 in 20X7 and $23,000 in 20X6. The advances are being repaid through payroll withholding. Repayments were $24,000 in 20X7 and $18,000 in 20X6.

Stockholder loans can present various substances over form issues that arise when certain events occur such as:

- Repayment is not made according to the stated terms, or
- Due on demand notes remain on the books for long periods of time.

For these types of loans, if there is no formal note or if the loan is due on demand, the loan should be classified as a current liability unless the stockholder waives their right to demand payment. This should occur whether there is a formal due on demand note or an informal understanding between the parties. If the mere existence of lack of intent is used to classify the loan as long-term, avoid using terminology such as "due on demand" and just disclose that the loan has no stated maturity and there is no intention by the lender to call the loan within the next 12 months.

EXAMPLE

The Company rents warehouses and office space located in New Jersey and South Carolina which is owned by its principal stockholder. Although there is no written agreement, the Company paid rent of $18,000 per month through December 20X3 and pays rent of $20,000 per month starting January 20X4. Rent paid to the related party for each of the years ended April 30, 20X3 and 20X2 totaled $224,212 and $216,110, respectively, and are included as operating expenses.

The Company has a $1,100,000 loan owed to its principal stockholder (classified as current) with no formal repayment terms for the years ended April 30, 20X3 and April 30, 20X2. The proceeds from this loan were used towards the acquisition of ABC Company. Interest expense related to the stockholder loan for the years ended April 30, 20X3 and 20X2 totaled $50,630 and $26,068, respectively. Accrued interest related to the stockholder loan for the years ended April 30, 20X3 and 20X2 totaled $4,521 and $0, respectively.

In addition, there is often confusion over whether interest should be imputed on related party receivables that do not provide for a stated rate of interest. This is because (1) interest must be imputed for tax purposes and (2) everyone remembers learning that "there is no such thing as an interest-free loan." However, if a loan is issued solely for cash (rather than property, goods, or services), with no exchange of other rights or privileges, then the loan is presumed to earn the stated rate of interest (ASC 835-30-25). In short, if a loan for cash is noninterest bearing, the GAAP rate of interest is 0%.

ASC Topic 850 references other specific disclosures that may be necessary for related parties in the areas of:

- Equity method and joint venture investments
- Guarantees
- Debt
- Equity
- Business combinations
- Consolidation
- Franchisors
- Limited liability entities

EXAMPLE

Barnes & Noble

Notes to Consolidated Financial Statements

23. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The Company believes that the transactions and agreements discussed below (including renewals of any existing agreements) between the Company and related third parties are at least as favorable to the Company as could have been entered into with unrelated parties at the time they were entered into. The Audit Committee of the Board of Directors utilizes procedures in evaluating the terms and provisions of proposed related party transactions or agreements in accordance with the fiduciary duties of directors under Delaware law. The Company's related party transaction procedures contemplate Audit Committee review and approval of all new agreements, transactions or courses of dealing with related parties, including any modifications, waivers or amendments to existing related party transactions. The Company tests to ensure that the terms of related party transactions are at least as favorable to the Company as could have been obtained from unrelated parties at the time of the transaction. The Audit Committee considers, at a minimum, the nature of the relationship between the Company and the related party, the history of the transaction (in the case of modifications, waivers or amendments), the terms of the proposed transaction, the Company's rationale for entering the transaction and the terms of comparable transactions with unrelated third parties. In addition, management and internal audit annually analyze all existing related party agreements and transactions and review them with the Audit Committee.

On February 27, 2017, B&N Education purchased MBS Textbook Exchange, Inc. (MBS), which was then privately-held and majority-owned by affiliates of Leonard Riggio (the MBS Purchase). MBS is a new and used textbook wholesaler, which also sells textbooks online and provides bookstore systems and distant learning distribution services. Following the MBS Purchase, Leonard Riggio, his affiliates and other members of the Riggio family ceased to have any ownership interest in MBS.

The Company entered into an agreement with MBS in 2009, which has a term of 10 years and contains restrictive covenants limiting the ability of the Company to become a used textbook wholesaler and placing certain limitations on MBS's business activities. The Company also entered into an agreement with MBS in fiscal 2011, pursuant to which, MBS agreed to purchase at the end of a given semester certain agreed upon textbooks, which the Company shall have rented to students during such semester. Total sales to MBS under this program were $0, $2 and $619 for fiscal 2017 prior to the MBS Purchase, fiscal 2016 and fiscal 2015, respectively. Total outstanding amounts payable to MBS for all arrangements, net of any amounts due, were $480 and $183 for fiscal 2017 and fiscal 2016, respectively.

The Company purchases new and used textbooks directly from MBS. Total purchases were $8,328, $7,092 and $14,594 for fiscal 2017 prior to the MBS Purchase, fiscal 2016 and fiscal 2015, respectively. MBS sells used books through the Barnes & Noble dealer network. The Company earned a commission of $198, $268 and $316 on the MBS used book sales in fiscal 2017 prior to the MBS Purchase, fiscal 2016 and fiscal 2015, respectively. In addition, Barnes & Noble hosts pages on its website, through which Barnes & Noble customers are able to sell used books directly to MBS. The Company is paid a fixed commission on the price paid by MBS to the customer. Total commissions paid to the Company under this arrangement were $47, $68 and $91 for fiscal 2017 prior to the MBS Purchase, fiscal 2016 and fiscal 2015, respectively.

EXAMPLE (CONTINUED)

In fiscal 2010, the Company entered into an agreement with TXTB.com LLC (TXTB), a subsidiary of MBS, pursuant to which the marketplace program on the Barnes & Noble website was made available through the TXTB website. The Company receives a fee from third-party sellers for sales of marketplace items sold on the TXTB website and, upon receipt of such fee, the Company remits a separate fee to TXTB for those sales. In fiscal 2011, the Company entered into an agreement with TXTB, pursuant to which the Company became the exclusive provider of trade books to TXTB customers through the TXTB website. TXTB receives a commission from the Company on each purchase by a TXTB customer. In fiscal 2013, the Company also entered into an agreement with MBS Direct, a division of MBS, pursuant to which the marketplace program on the Barnes & Noble website was made available through the MBS Direct website. The Company receives a fee from third-party sellers for sales of marketplace items sold on the MBS Direct website and, upon receipt of such fee, the Company remits a separate fee to MBS Direct for those sales. Total commissions paid to TXTB and MBS Direct under these arrangements were $645, $515 and $429 during fiscal 2017 prior to the MBS Purchase, fiscal 2016 and fiscal 2015, respectively. Outstanding amounts payable to TXTB and MBS Direct were $5 and $0 for fiscal 2017 prior to the MBS Purchase and fiscal 2016, respectively.

In fiscal 2010, the Company entered into an Aircraft Time Sharing Agreement with LR Enterprises Management LLC (LR Enterprises), which is owned by Leonard Riggio and Louise Riggio, pursuant to which LR Enterprises granted the Company the right to use a jet aircraft owned by it on a time-sharing basis in accordance with, and subject to the reimbursement of certain operating costs and expenses as provided in, the Federal Aviation Regulations (FAR). Such operating costs were $153, $63 and $155 during fiscal 2017, fiscal 2016 and fiscal 2015, respectively. LR Enterprises is solely responsible for the physical and technical operation of the aircraft, aircraft maintenance and the cost of maintaining aircraft liability insurance, other than insurance obtained for the specific flight as requested by the Company, as provided in the FAR.

The Company has leases for two locations for its corporate offices with related parties: the first location is leased from an entity, in which Leonard Riggio has a majority interest, under a lease expiring in 2023, and the second location is leased from an entity, in which Leonard Riggio has a minority interest, under a lease expired in 2016. In fiscal 2017, the second location was extended through 2023. Both locations were rented at an aggregate annual rent, including real estate taxes, of approximately $9,637, $7,784 and $6,834 during fiscal 2017, fiscal 2016 and fiscal 2015, respectively.

The Company leased an office/warehouse from a partnership, in which Leonard Riggio had a 50% interest, pursuant to a lease terminated effective December 30, 2015. The space was rented at an annual rent of $456 and $262 during fiscal 2016 through the date of termination and fiscal 2015, respectively. During fiscal 2015, the Company received credits totaling $418, representing the net effect of inadvertent overpayment of construction expenses and underpayment of base rent previously paid. Net of subtenant income, the Company paid rent of $179 during fiscal 2016 through the date of termination and received $174 during fiscal 2015 due to credits noted above.

The Company was provided with national freight distribution and trucking services by Argix Direct Inc. (Argix), a company in which a brother of Leonard Riggio owned a 20% interest. The Company paid Argix $19,102 and $47,536 for such services during fiscal 2016 through the date of termination and fiscal 2015, respectively. The contracted relationship between Argix and the Company has terminated due to Argix exiting the industry during fiscal 2016.

DISCUSSION QUESTION

David Inc. is a successful manufacturing company owned by two elderly brothers. The brothers and other family members wish to purchase the assets of Carol Co., under Chapter 7 liquidation, for $1,800,000. The acquisition will be financed primarily with bank debt. In order to obtain favorable financing for the acquisition, David Inc. borrows the money, due to its excellent credit history and forwards the funds to Carol. Carol Co. makes a product similar to David and is organized as a separate corporation owned by the brothers and their children. Both companies are S corporations.

Carol Co. is expected to generate sufficient cash to begin servicing the debt within a few months of commencing operations. Monthly, it reimburses David for the principal and interest paid to the bank.

Discuss the related party accounting and disclosure issues.

Discussion Points

Because the bank loan is David's, it must reflect the loan (and all related debt disclosures) on its separate financial statements. It will carry a corresponding receivable from Carol Co. In short, two separate accounting transactions have occurred – a bank loan and an intercompany loan.

As Carol makes payments, David is in effect reimbursed for the principal and interest payments it is making on the debt. However, it would not be appropriate to offset reimbursements of interest against interest expense, as David would show substantial bank debt with no related interest expense. Therefore, both the interest expense and income would be shown gross.

The use of the proceeds for the affiliate's benefit would be disclosed, as would the interest income in operations earned on the intercompany balance.

On Carol's side, the amounts due to David do not carry the same formalized maturities, terms and conditions as the bank debt. However, it would be meaningful to indicate why the large payable was incurred and describe the general terms of the affiliate's debt which must be retired by Carol's repayment.

Note that it becomes more important to reflect related party transactions on terms equivalent to arm's length when affiliated entities have different ownership, as in this case. Therefore, care should be taken not to shift income arbitrarily from one company to the other. For example, in this case, one could argue that Carol's incremental borrowing rate would be much higher than David's. But if higher interest were charged on the intercompany debt than on the bank debt, the shareholders of David could be accused of using this transaction to profit at the expense of Carol's stockholders.

ASC Topic 810, Consolidation

ASC Topic 810 requires that if an entity has control of a business, then that entity should consolidate 100% of the assets and liabilities of that business. Control can be demonstrated as either entities under common control or entitles having majority ownership of the business's outstanding shares.

When entities under common control exist, the reporting entity must determine if it is the primary beneficiary of a variable interest entity (VIE) and if it is, then the entity must consolidate 100% of the assets and liabilities of the VIE. FASB states in ASC Section 810-10-30-1, if the primary beneficiary of a variable interest entity and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and any noncontrolling interest of the VIE at the VIE's current carrying amounts.

The following definitions are relevant to this issue:

- Primary Beneficiary – An entity that consolidates a variable interest entity has the power to direct the activities of the VIE that most significantly affect the VIE's economic performance (power) and the obligation to absorb a majority of the VIE's expected losses, receive a majority of the VIE's expected residual returns, or both (economics)

- Variable Interest Entity (VIE) – A legal entity subject to consolidation according to the guidance in ASC Topic 810

- Variable Interests – The investments or other interests that will absorb portions of a VIE's expected losses or receive portions of the entity's expected residual returns

ASU 2015-02, CONSOLIDATION (ASC TOPIC 810) AMENDMENTS TO THE CONSOLIDATION ANALYSIS

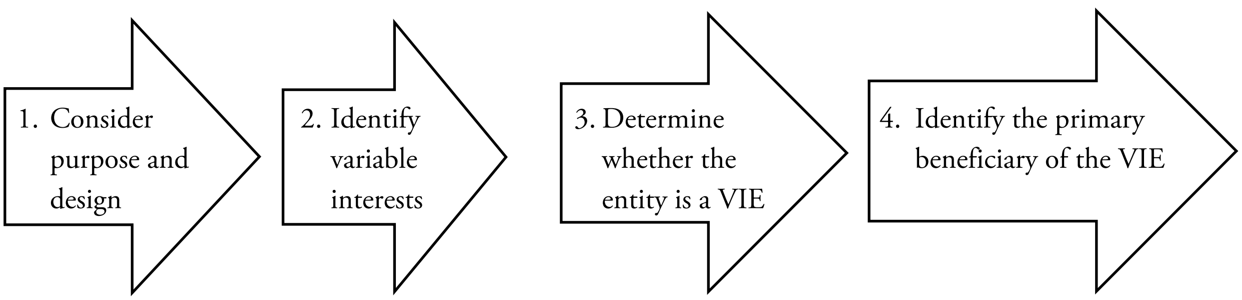
The Update changed both the variable interest and the voting models. This has resulted in reporting entities reevaluating their consolidation determinations and increasing disclosures. The Update affects all reporting entities that have variable interests in other legal entities.

Much of ASU 2015-02 focuses on consolidation guidance for investment funds (such as money market mutual funds). Because a decision maker of a VIE may be the primary beneficiary which would require consolidation, this may be an asset manager or general partner for an investment fund. The Update eliminated the indefinite deferral for money market mutual fund consolidation, but also permanently exempted a reporting entity from consolidating money market funds that are required to comply with the Investment Company Act of 1940. The Update also eliminated the presumption in the voting model that a general partner controls a limited partner.

Instead of focusing on specific industry impact, this section will focus on broader consolidation concepts in ASU 2015-02. The Update changed the criteria for determining:

- When fees paid to a decision maker or service provider are a variable interest
- Whether an entity is a Variable Interest Entity (VIE)
- Whether a reporting entity is the primary beneficiary of a VIE

The variable interest model has four steps:



- Consider the purpose and design of the entity (the “by design” approach) – This did not change with the Update. The “by design” approach is a qualitative approach that determines the variability the entity is designed to create and pass along to its interest holders by evaluating the nature of the entity’s risks and the entity’s purpose when it was created.

- Identify variable interests – The reporting entity determines whether it has a variable interest in the other entity it is evaluating for consolidation. In doing this, it evaluates the risks the other entity was designed to create and pass along to its interest holders. Examples of variable interests are equity interests, guarantees, subordinated debt interests, and written call options because they absorb risk created and distributed by the other entity. Fees received by decision makers may also represent variable interests.

  The Update modified the criteria for evaluating whether fees are a variable interest, as well as criteria for evaluating other interests. It also modified evaluation of interests held by related parties and de facto agents.

  Unchanged, however, are fee arrangements that expose a reporting entity to loss risk and variable interests as fees that are not customary in the industry.

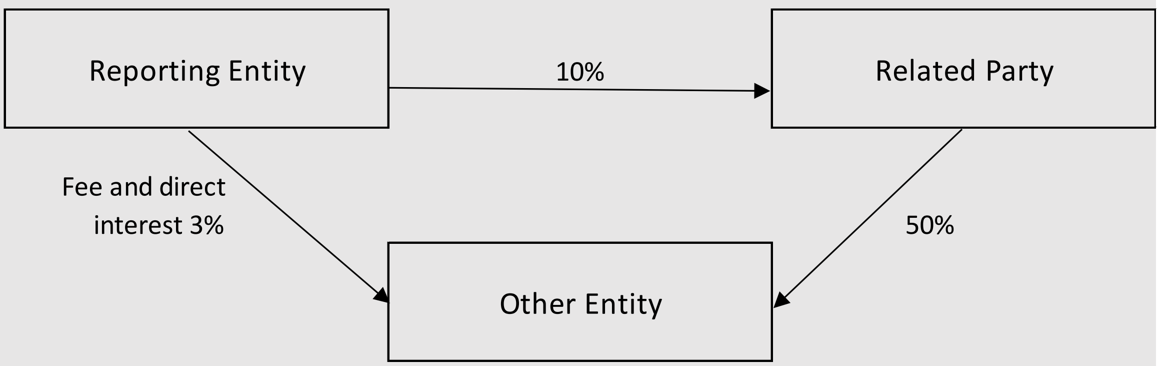
  The Update maintained the threshold of “more than an insignificant amount” for assessing whether a decision maker holds an interest that would absorb the other entities’ expected losses or residual returns. Reporting entities that previously concluded consolidations based on FIN 46(R)'s "trivial" threshold should reassess its consolidation conclusions.

Regarding related parties when evaluating whether fees results in a variable interest, the Update included a new concept of "indirect" interest. A reporting entity decision maker must include not only its direct interests but also its proportionate share of a related party's indirect interests. The Update requires a reporting entity first to assess whether it individually has power and benefits before evaluating related party provisions.

EXAMPLE

A reporting entity decision maker has a 3% direct interest in an other entity and a 10% equity interest in a related party that, in turn, owns a 50% equity interest in the same other entity. The reporting entity and related party are not under common control. Also, the fee arrangement is commensurate with the effort required to provide the services and only includes customary terms.

What is the reporting entity's total interest for evaluating whether the fee arrangement is a variable interest?



Following the Update, the answer is: 3% + (10% X 50%) = 8%

Guidance prior to the Update, the answer is 3% + 50% = 53%

- Determine whether the entity is a VIE – An other entity is a VIE if it meets any of the following criteria:
  - The other entity does not have enough equity to finance its activities without additional subordinated financial support.
  - The at-risk equity holders in the aggregate lack any of the following:
    - The power, through voting rights or similar rights, to direct the activities that most significantly impact the entity's economic performance.

      The Update changed the power evaluation when determining whether the equity holders, in the aggregate, of the other entity at risk lack the characteristics of a controlling financial interest. Under the ASU, limited partners with equity at risk lack power if they do not hold substantive **kick-out rights** or substantive **participating rights** over the general partner. Nonsubstantive rights are not included in the evaluation.

Kick-out rights are the right to remove the decision maker and to dissolve the entity without cause. Participating rights are the right to block or participate in significant financial or operating decisions.

The Update requires that, when determining whether the at-risk equity holders of an other entity have power, a reporting entity would first evaluate the voting rights model before evaluating the substance of kick-out or participating rights.

    - The obligation to absorb the other entity's expected losses.

    - The right to receive the other entity's expected residual returns.

  - The legal entity is structured with nonsubstantive voting rights

- Identify the primary beneficiary of the VIE – A primary beneficiary analysis is a qualitative assessment of power and benefits. A reporting entity must consolidate a VIE if it has a controlling financial interest in the VIE, determined by having both of the following:

  - The power to direct the economic activities that most impact the VIE's performance.

  - The obligation to absorb the VIE's losses or benefits that potentially could be significant.

  The Update no longer requires a majority threshold. The previous guidance in FIN 46(R) had a quantitative approach requiring consolidation if the reporting entity absorbed a majority of losses or benefits.

  The phrase "potentially could be significant" means that the threshold is now based on what could happen, and not what would happen. This obviates the expected-value method of calculating the weighted-average probability of all possible outcomes over the other entity's life. Instead, a reporting entity assesses losses and benefits that could occur, even if not expected.

  The Update does not require a primary beneficiary to absorb <u>both</u> losses and benefits. It need only potentially absorb one or the other.

EXAMPLE

A reporting entity has the power to direct the economic activities of a VIE, guaranteed the VIE's obligations, and is not entitled to receive the VIE's benefits but could absorb the VIE's losses. The reporting entity would be the VIE's primary beneficiary even though it was not entitled to receive the VIE's benefits.

Regarding fee arrangements and the benefit/loss assessment, the Update excludes certain fee arrangements that do not expose the reporting entity to losses. These excluded fee arrangements must meet both of the following:

- The fees are compensation for services provided and recommensurate with the level of effort required to provide those services.
- The compensation amount is negotiated on an "arms-length basis" and is based on terms and conditions that are customarily present for similar services in the industry.

The **Update became effective** for public business entities in 2016 (after December 15, 2015). It became effective for all other entities one year later (2017) for annual periods and two years later (2018) for interim periods.

FASB September 2017 Exposure Draft Related to ASU 2015-02

In September 2017, the FASB issued a Proposed Update in response to stakeholders' concerns that the consolidation guidance in ASC Topic 810, *Consolidations*, is difficult to understand and navigate. To address those concerns, the amendments in this Proposed Update would reorganize and clarify certain items within the consolidation guidance. Comments were due in December 2017, and the FASB is still working on this topic.

Some of the amendments in this Proposed Update include the amendments in a previously-exposed Proposed Update, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*. The FASB subsequently released this VIE proposal as ASU 2018-17 in October 2018.

If adopted, this Proposed Update would become ASC 812 and supersede the existing ASC Topic 810. It will affect all reporting entities that are required to determine whether they should consolidate a legal entity. Specific changes would be:

- Separate scope, guidance, and disclosure for variable interest entities in ASC Topic 812-20 and for voting interest entities in ASC Topic 812-30.
- Clarify existing language about when an implicit variable interest exists.
- Clarify the concept of "expected" as this term applies to variable interests, expected losses, and expected residual returns.

- Move rarely-used “Consolidation of Entities Controlled by Contract” to ASC 958, Not-For-Profit Entities, because it is applicable only for not-for-profit entities.

- Remove research and development entity guidance.

The FASB has not set the effective date. Adoption will be retrospective to all relevant prior periods beginning with the fiscal year in which ASU 2015-02 was initially adopted.

ASU 2016-17, CONSOLIDATION (TOPIC 810) INTEREST HELD THROUGH RELATED PARTIES THAT ARE UNDER COMMON CONTROL

This new guidance may change a reporting entity’s consolidation conclusion under ASU 2015-02, Consolidation (ASC Topic 810) Amendments to the Consolidation Analysis, when a decision maker and its related parties holding a VIE are under common control.

ASU 2015-02 required a single decision maker performing a primary beneficiary evaluation to consider its indirect interests held by related parties under common control in their entirety. Under ASU 2016-17, the evaluation changes to a proportionate basis. It does not change how a decision maker evaluates its indirect interest when determining whether its fee arrangement is a variable interest.

ASU 2016-17 also does not change a primary beneficiary’s characteristics in the VIE model. A VIE’s primary beneficiary still has both of the following:

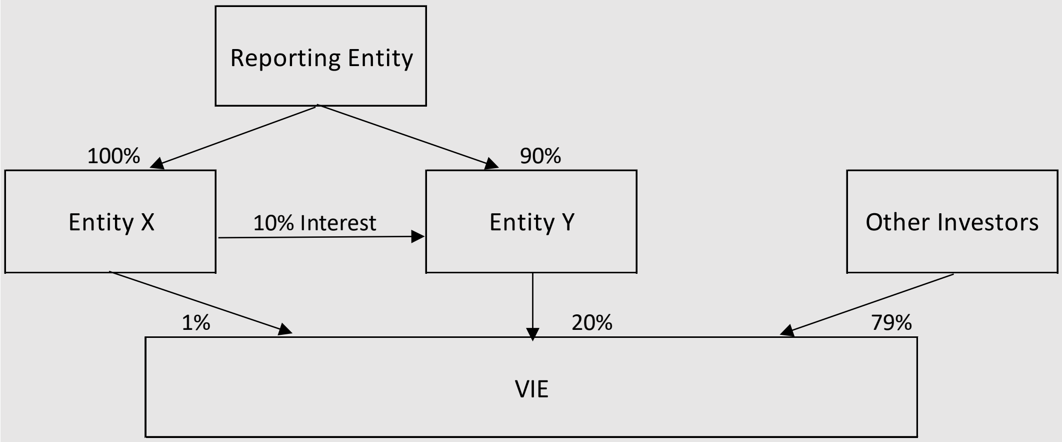
- The power to direct the economic activities that most impact the VIE’s performance

- The obligation to absorb the VIE’s losses or benefits that potentially could be significant

When a reporting entity performs a primary beneficiary analysis, a single decision maker considers whether it has benefits/losses on an individual basis without considering its indirect interests. If the decision maker does not have benefits/losses, it will now consider its indirect interests held by its related parties (including those under common control) on a proportionate basis. If there are neither direct nor indirect benefits/losses, the reporting entity decision maker will continue to follow the remaining steps of the primary beneficiary analysis which are unchanged by the Update.

EXAMPLE

Entity X forms a limited partnership with related party Entity Y with 10% ownership, and Entity X holds a 1% general partnership equity interest in a VIE. Entity X makes all significant decisions for the VIE through its general partner interest. Entity Y holds a 20% interest in the VIE. Entities X and Y are under common control.



Conclusion under prior guidance ASU 2015-02:

Entity X has power through its equity interest in the VIE, and would conclude that its 1% direct equity interest does not absorb benefits/losses that could potentially be significant to the VIE.

The reporting entity's total (direct plus indirect) interest is 21% (1% direct plus 20% indirect). Entity X considers Entity Y's full 20% indirect interest because both entities are under common control. This percentage would be considered significant; therefore, Entity X would be the primary beneficiary and consolidate the VIE.

Conclusion under ASU 2016-17:

Entity X still has power through its equity interest in the VIE, and likely would conclude that its total interest of 3% (1% direct plus (10% X 20%) indirect) does not absorb benefits/losses that could potentially be significant to the VIE.

The reporting entity's total (direct plus indirect) interest is 21% (1% direct plus 20% indirect). Entity X considers Entity Y's full 20% indirect interest because both entities are under common control. This percentage would be considered significant; therefore, the related party group would have both power and benefits. As a result, either Entity X or Entity Y, depending on whichever is most closely associated with the VIE, would be the primary beneficiary and consolidate the VIE.

The ASU is effective for public business entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities, the amendments in the ASU are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period.

ASU 2018-17, CONSOLIDATION (ASC TOPIC 810) TARGETED IMPROVEMENTS TO RELATED PARTY GUIDANCE FOR VARIABLE INTEREST ENTITIES

On October 31, 2018, the FASB issued ASU No. 2018-17, *Targeted Improvements to Related Party Guidance for Variable Interest Entities*. This Update reduces the cost and complexity of financial reporting associated with consolidation of variable interest entities. A VIE is an organization in which consolidation is not based on a majority of voting rights.

The new guidance supersedes the private company alternative for common control leasing arrangements in ASU 2014-07, and expands it to all qualifying common control arrangements. This is the sixth PCC recommendation to be endorsed by the FASB. For entities not under common control, private companies would continue to apply the VIE model.

The FASB issued this ASU to simplify VIE guidance for private companies based on recommendations from the PCC. The ASU addresses stakeholder concerns that it is difficult to apply the previously-existing consolidation guidance for VIEs under common control.

The ASU affects organizations that are required to determine whether they should consolidate a legal entity under the guidance within the Variable Interest Entities Subsections of Subtopic 810-10, Consolidation—Overall, including private companies that have previously elected the accounting alternative for leasing arrangements under common control.

This Update amends two aspects of the related party guidance in ASC Topic 810. It:

1. Adds an elective private-company scope exception to the VIE guidance for entities under common control.

   A private company could make an accounting policy election to not apply VIE guidance to legal entities under common control when meeting certain criteria. This includes common control leasing arrangements. This election must be applied to all current and future legal entities under common control that meet the criteria. A private company will be required to continue to apply other consolidation guidance, specifically, the voting interest entity guidance.

   Additionally, a private company electing the alternative is required to provide detailed disclosures about its involvement with, and exposure to, the legal entity under common control.

   This accounting alternative is expected to reduce practice diversity in applying VIE guidance to private companies under common control because it is expected that many private companies will elect the alternative.

   This accounting alternative also is expected to improve financial reporting relevance to financial statement users by providing additional **disclosures** structured in a more consistent manner.

2. Considering indirect interests held through related parties under common control for determining whether fees paid to decision makers and service providers are variable interests.

   The ASU requires considering indirect interests held through related parties under common control on a proportional basis rather than as the equivalent of a direct interest in its entirety which was required in the previously-existing GAAP.

   The likely result will be more decision makers not consolidating VIEs. It will also create alignment between determining whether a decision-making fee is a variable interest and determining whether a reporting entity within a related party group is the primary beneficiary of a VIE.

   It removes a sentence in ASC Section 810-10-55-37D regarding evaluating fees paid to decision makers to conform with ASU 2016-17, *Interests Held Through Related Parties That Are Under Common Control*, issued in October 2016.

ASU 2018-17 does not incorporate its proposed changes to the related party guidance in the VIE primary beneficiary assessment in the FASB's June 22, 2017 Exposure Draft, including amendments to the guidance in ASC Section 810-10-25-44 (frequently referred to as the "related party tiebreaker test"). Based on comment letter feedback, the FASB excluded these items from the final ASU and, instead, added them to its research agenda.

VIE Consolidation Basics

In March 2014, the FASB issued ASU 2014-07, *Consolidation (ASC Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the Private Company Council*. This Update introduced a private-company scope exception to the VIE guidance for certain entities that are under common control and have leasing arrangements that meet certain conditions.

When a reporting entity has a variable interest in another legal entity, it must determine whether it should consolidate that other legal entity. This determination starts with the reporting entity evaluating whether that other legal entity is subject to a general exception to the consolidation requirements in ASC Topic 810-10. If a legal entity is not subject to a general exception, the evaluation should focus on whether the other legal entity is subject to a scope exception to the VIE model.

If no general scope exception or VIE scope exception exists, the reporting entity determines whether the other legal entity is a VIE. If it is a VIE, the reporting entity evaluates whether it is the primary beneficiary of the VIE. Under ASC Topic 810, the primary beneficiary of a VIE is defined as the entity that has both:

1. The "power to direct the activities of a VIE that most significantly impact the VIE's economic performance" (the "power criterion").

2. The obligation to absorb the VIE's losses or the right to receive benefits from the VIE that could potentially be significant to the VIE. This is referred to as the "economics criterion".

   ASU 2015-02 and ASU 2016-17 amended the economics criterion to require a reporting entity that is a single decision maker to consider, when assessing the effects of related party relationships, interests held by its related parties (including de facto agents) only if the reporting entity has a direct interest in the related parties.

   Under ASC Topic 810, as amended by both of these ASUs, interests held through related parties under common control are considered:

   (1) In their entirety as direct interests held by the decision maker in the evaluation of whether the decision maker's fee arrangement is a variable interest,

   and

   (2) Proportionately as an indirect interest held by the decision maker in the primary beneficiary analysis.

Key Provisions of ASU 2018-17

ASU 2018-17 broadens the existing accounting alternatives available to private companies by allowing all legal entities under common control to elect not to apply the VIE guidance as long as the reporting entity, the common-control parent, and the legal entity being evaluated for consolidation:

1. Are not public business entities,

   and

2. Meet the criteria in ASC Section 810-10-15-17AD, which ASU 2018-17 added, that:

   A legal entity need not be evaluated by a private company reporting entity under the guidance in the VIE subsections if all the following criteria are met:

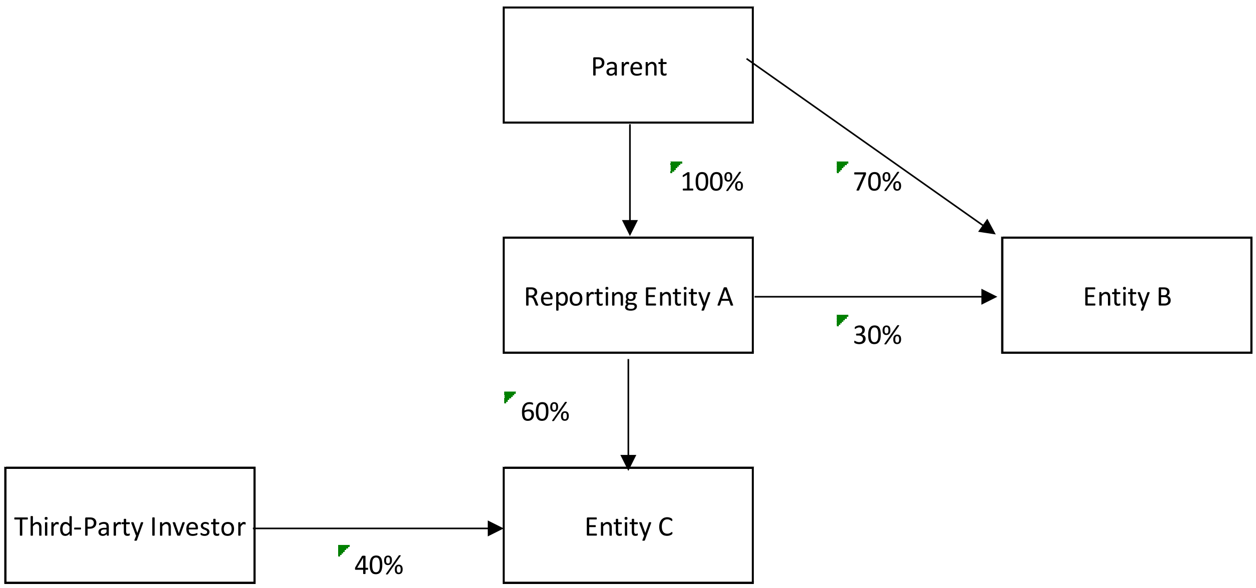
   a. The reporting entity and the legal entity are under common control.

      ASC Section 810-10-15-17AE, which ASU 2018-17 also added, provides guidance on applying this criterion in determining that the reporting entity and the legal entity are under common control. Specifically, ASC Section 810-10-15-17AE provides that solely for the purpose of applying this criterion, a private company reporting entity should consider only the voting interest model. Thus, a private company reporting entity is not required to consider the VIE guidance when determining whether this criterion is met.

   b. The reporting entity and the legal entity are not under common control of a public business entity.

c. The legal entity under common control is not a public business entity.

d. The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of ASC Topic 810. The VIE subsections shall not be applied when making this determination.



Other facts:

- None of the entities are Public Business Entities; meaning criteria (b) and (c) are met.
- There are no contractual arrangements through which a third-party controls Entity B or Entity C.
- Third-Party Investor does not have substantive participating rights in Entity C.
- Parent has a controlling financial interest in Entity A, Entity B, and Entity C through its direct and indirect voting interests. Therefore, A, B, and C are under common control for purposes of applying criterion (a) in ASC 810-10-15-17AD.

Conclusion:

Entity A can apply the private company scope exception of ASC Section 810-10-15-17AD to Entity B because Entity A does not directly or indirectly have a controlling financial interest in Entity B, which means it also meets criterion (d).

However, Entity A cannot apply the scope exception to Entity C because Entity A has a controlling financial interest in Entity C which means it does not meet criterion (d).

Common-Control Considerations

The FASB guidance does not specifically define common control; however, the FASB clarifies common control in its Background Information and Basis for Conclusions of both ASU 2014-07 and ASU 2015-02.

The FASB acknowledged in ASU 2014-07 that common control is broader than the SEC observations on EITF Issue 02-5. The SEC indicated that common control exists between (or among) separate entities only in the following situations:

- An individual or enterprise holds more than 50% of the voting ownership interest of each entity.
- Immediate family members hold more than 50% of the voting ownership interest of each entity, with no evidence that those family members will vote their shares in any way other than in concert.
  1. Immediate family members include a married couple and their children, but not the married couple's grandchildren.
  2. Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.
- A group of shareholders holds more than 50% of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists.

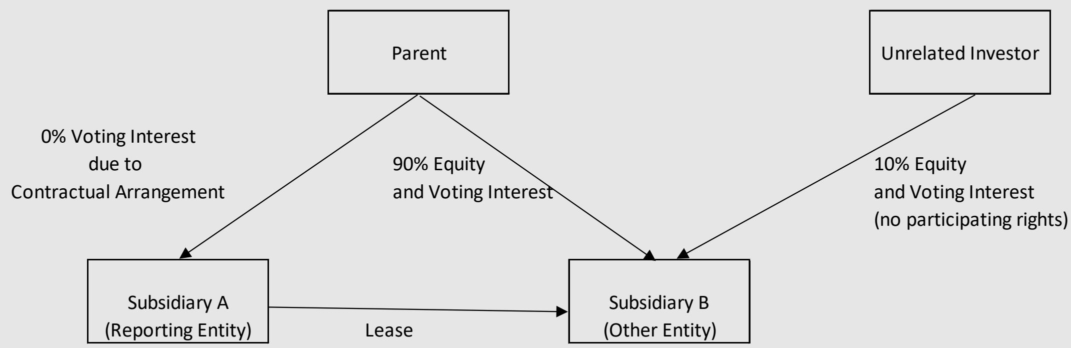
In addition, the FASB states that because common control is not an entirely new concept within U.S. GAAP, stakeholders in current practice should be able to assess whether common control exists.

ASU 2018-17 is consistent with the above FASB common control clarification in ASU 2014-07, with one key exception. ASU 2018-17 permits a reporting entity to apply the new private company scope exception only if the reporting entity and other legal entity are under common control on the common control parent's voting interest model. The Update does not change how entities determine whether an arrangement is under common control when applying other guidance.

The implication is that since ASU 2014-07 did not define common control or limit how to determine whether entities that intend to apply the scope exception are under common control, it is possible that a reporting entity applying ASU 2014-07 would not meet the criteria to apply the scope exception in ASU 2018-17.

EXAMPLE

Subsidiary A is the reporting entity, which is not eligible to apply the scope exception in ASU 2018-17 because its Parent is the primary beneficiary of Subsidiary A through a contractual arrangement and does not hold a voting interest in Entity A. As a result, Subsidiary A and Subsidiary B are not under common control of Parent solely on the basis of voting interest.



Applicability of the PCC Scope Exception to Parent-Subsidiary Relationships

The FASB explains in ASU 2015-02 that under the VIE model, entities under common control would include subsidiaries controlled (directly or indirectly) by a common parent or a subsidiary and its parent. A parent and its subsidiary are entities under common control, and the private company scope exception in ASU 2018-17 cannot be applied to parent-subsidiary common control relationships when the parent is the reporting entity.

To be under common control for applying criterion (a) in ASC Section 810-10-15-17AD, a parent must have a controlling financial interest through its **voting interest** in both the reporting entity and the legal entity. If the parent is also the reporting entity, criterion (d) in ASC Section 810-10-15-17AD would not be met because the reporting entity (in this case, the parent) would have a controlling financial interest in the legal entity through its voting interest.

Definition of a Public Business Entity (PBE)

The ASC master glossary defines a PBE:

- As a business entity that the SEC requires to file or furnish financial statements or that voluntarily files or furnishes financial statements with the SEC. This includes voluntary filers and includes other entities whose financial statements or financial information are required to be or are included in a filing.

- Because its financial statements or financial information are included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

- Certain nonpublic entities may meet the definition of a PBE because of statutory or regulatory requirements. These entities would not be eligible to apply the private company scope exception in ASU 2018-17.

As previously explained, a reporting entity cannot apply the PCC scope exception if the reporting entity, common control parent, or legal entity is a PBE. This is stated in ASC Section 810-10-15-17AD(b) and (c).

A reporting entity that wishes to apply the PCC scope exception in ASU 2018-17 is required to determine whether the reporting entity and legal entity are under common control solely based on the voting interest model. As a result, ASC Section 810-10-15-17AD criterion (a) would be met when:

- A common control parent has the majority vote in both the reporting entity and the other legal entity,

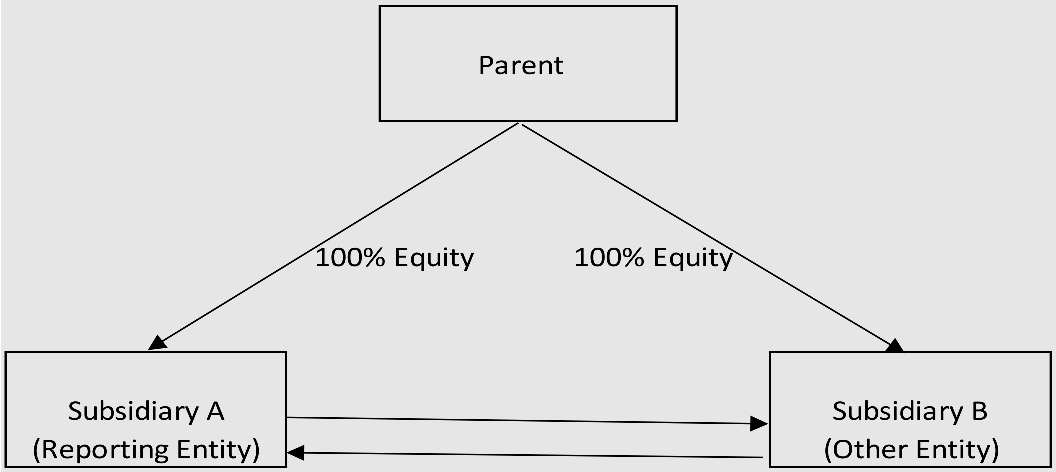
  and

- **No other investors have substantive participating rights.**

In this situation, the reporting entity and other legal entity would be under common control. Also, criterion (d) would be met because the common control parent rather than the reporting entity would have a controlling financial interest in the legal entity. Consequently, the reporting entity would be eligible to apply the scope exception provided that the common control parent, reporting entity, and legal entity are not PBEs in accordance with criteria (b) and (c) in ASC Section 810-10-15-17AD.

EXAMPLE

Reporting unit Subsidiary X would be eligible to apply the scope exception with respect to legal entity Subsidiary Y only if the three entities are not PBEs. Subsidiary X would be able to apply the scope exception because Parent Company, the common control parent, has a controlling financial interest through its majority voting interest in both X and Y.



ASU 2018-17 supersedes the currently-existing accounting alternative under ASC 810 that originated from ASU 2014-07. The Update's new guidance on common control relationships for private companies encompasses existing leasing arrangements that qualified for the previous scope exception. Like all accounting alternatives, the private-company scope exception provided by ASU 2018-17 is an accounting policy election. If elected, it would apply to all legal entities that qualify for it within the reporting entity.

As a result of meeting the criteria in ASC Section 810-10-15-17AD for applying the new scope exception, specifically criterion (d), private company reporting entities that apply the scope exception and therefore do not consolidate under the VIE model would also not consolidate under the voting interest entity model since those entities would not have qualified for the scope exception if they had a controlling financial interest under the voting interest entity model. Consequently, private company reporting entities that apply the scope exception will be required to provide enhanced disclosures like those required of entities that apply the VIE guidance.

Evaluating Fees Paid to a Decision Maker

ASC Topic 810 currently requires indirect interests held by related parties under common control to be considered in their **entirety** in the evaluation of whether a decision maker's fee arrangement is a variable interest. ASU 2016-17 amended ASC Topic 810 to require consideration of these indirect interests on a **proportionate** basis in the primary beneficiary analysis but did not align current guidance with the considerations related to the variable interest analysis.

ASU 2018-17 now aligns the guidance by removing one sentence in ASC Section 810-10-55-37D12 to conform the guidance in that paragraph with the amendments in ASU 2016-17. ASU 2018-17 removes the following sentence: "Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety."

Practice Point: Under current guidance, asymmetry exists in evaluating the way a decision maker's indirect interests are held through a related party under common control for:

(1) The identification of a variable interest,

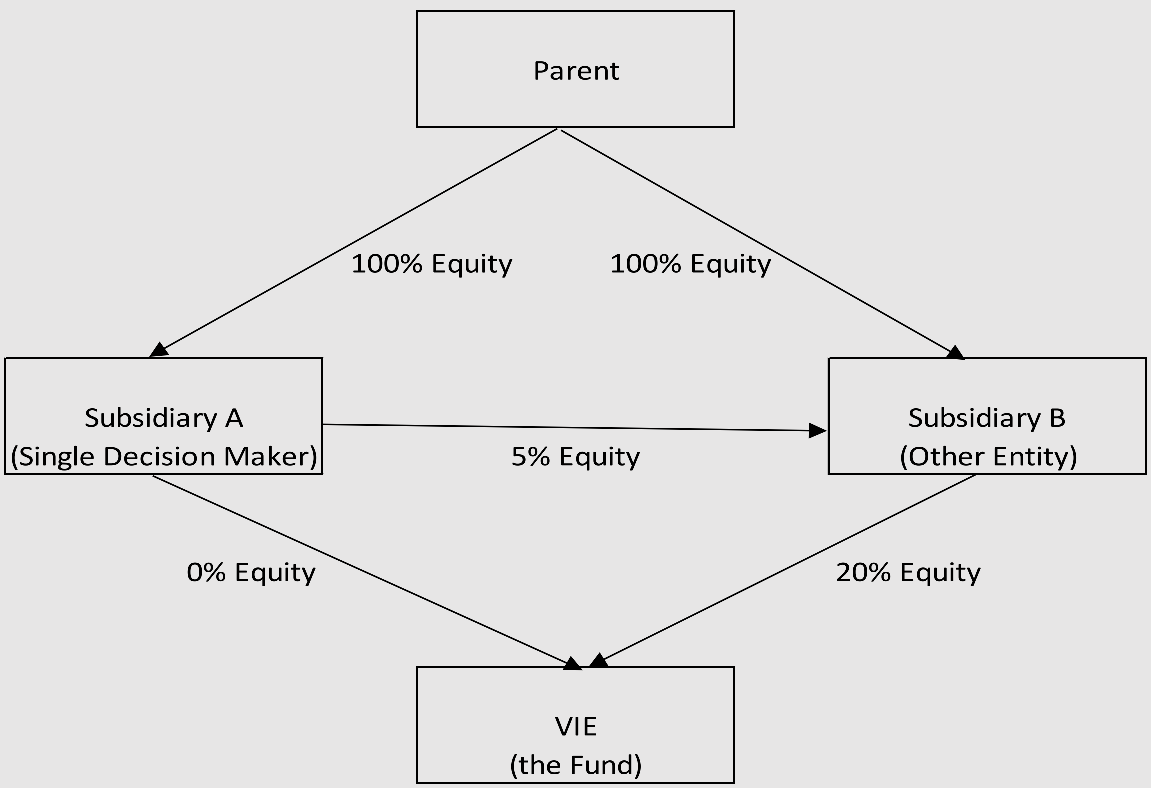
and

(2) The determination of a VIE's primary beneficiary in the assessment of related party relationships.

This asymmetry changes under ASU 2018-17 because the indirect interest evaluation becomes aligned in both analyses. As a result, it is less likely that a decision maker applying ASU 2018-17 would be required to apply the VIE model because fewer fee arrangements would qualify as variable interests.

EXAMPLE

A fund's single decision maker (Sub A) has only a 5% interest in a related party (Sub B) under common control, and that Subsidiary B holds a 20% interest in a fund that is a VIE. The primary beneficiary analysis conclusion reached under current existing guidance would be different than the conclusion reached under ASU 2018-17.



EXAMPLE (CONTINUED)

Under ASC Topic 810 as amended by ASU 2015-02 and ASU 2016-17, the single decision maker would have a variable interest because the 20% interest held by the entity under common control would be treated as the decision maker's interest in its entirety. When performing the primary beneficiary analysis, the decision maker would treat only 1% (20% times 5%) of the interest as its own in determining whether it has satisfied the economics criterion. Accordingly, the decision maker's fee arrangement would satisfy the power criterion, but the fee arrangement itself would not satisfy the economics criterion.

However, under ASU 2018-17, the decision maker will consider only the 1% interest as its own when evaluating whether the fee arrangement was a variable interest. This proportionate approach is like its assessment of the interest attributable to the decision maker in the primary beneficiary step under current guidance.

Thus, the fee arrangement would not be a variable interest provided that the fees meet the ASC Topic 810 definition of "commensurate" and "at market". The decision maker would therefore not be required to apply the VIE model because it does not have a variable interest.

Commensurate means that the fees are compensation for services provided and are commensurate with the level of effort required to provide those services. At market means the service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

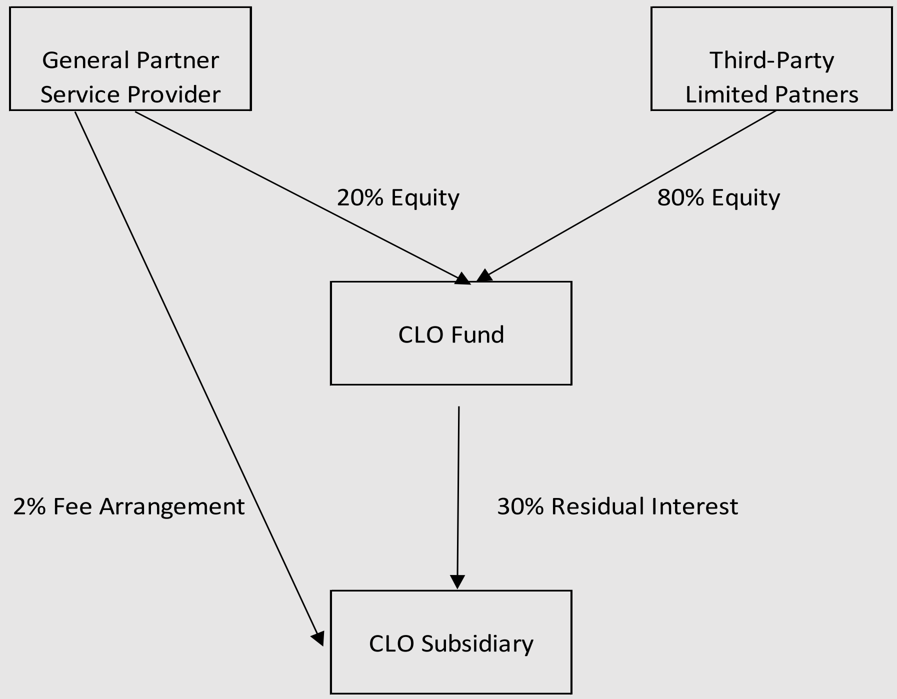
The changes made by ASU 2018-17 do not affect interests held through a subsidiary since such interests should be treated as direct interests of the consolidated group in a consolidation assessment. The example below illustrates this change.

EXAMPLE

A General Partner Service Provider owns 20% of CLO Fund. The remaining 80% is owned by unrelated Third-Party Limited Partners. CLO Fund owns a 30% residual interest in CLO Subsidiary. General Partner Service Provider has a management agreement with, and acts as the decision maker for, CLO Subsidiary. Under the agreement, General Partner Service Provider receives fees that are deemed commensurate and at market.

Both CLO Fund and CLO Subsidiary have been deemed VIEs because neither of them has substantive participating rights or kick-out rights. Assume that General Partner Service Provider has power over CLO Fund, which, in conjunction with the 20% equity interest of General Partner Service Provider in CLO Fund, results in the consolidation of CLO Fund by General Partner Service Provider.

EXAMPLE (CONTINUED)



Because General Partner Service Provider consolidates CLO Fund, CLO Fund's 30% residual interest in CLO Subsidiary represents a direct interest of General Partner Service Provider in CLO Subsidiary. Thus, it is not considered an indirect interest that would be assessed on a proportionate basis.

Consequently, General Partner Service Provider would be the primary beneficiary of CLO Subsidiary because:

(1) The General Partner Service Provider management agreement represents a variable interest in CLO Subsidiary and provides General Partner Service Provider with power over CLO Subsidiary,

and

(2) CLO Fund's 30% residual interest in CLO Subsidiary, which represents a 30% direct interest in CLO Subsidiary for General Partner Service Provider, meets the economics criterion.

Effective Date and Transition

For PBEs, ASU 2018-17 is effective for fiscal years beginning after December 15, 2019, including interim periods. For private companies, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early adoption is permitted. In a manner consistent with previously-issued ASUs amending ASC Topic 810, ASU 2018-17 has retrospective application with a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented.

Under ASC Topic 810, reporting entities determine whether a legal entity is a VIE and whether they must consolidate the VIE at the reporting entity's initial involvement with the legal entity. ASU 2018-17, however, allows the reporting entity to use the Update's application date if it is not practicable to make the determination at the initial involvement date.

Practice Point: In March 2016, the FASB issued ASU 2016-03, Effective Date and Transition Guidance, which eliminated the effective dates of PCC alternatives. The effect was that private companies could adopt a PCC accounting alternative without following guidance in ASC Topic 250, *Accounting Changes and Error Corrections*, to incur a change in accounting or to need a preferability assessment.

By contrast to other PCC accounting alternatives, ASU 2018-17 does include an effective date and transition guidance. The FASB decided that electing not to follow ASC Topic 250 (by adopting ASU 2016-03) would be more difficult if the private reporting entity had many legal entities.

The FASB intended for the December 15, 2020 effective date to give private companies enough time to decide whether they want to elect using the new private company scope exception. However, reporting entities that consider making this election after the effective date of ASU 2018-17 will be required to follow guidance in ASC Topic 250 and perform a preferability assessment and change in accounting presentation.

ASU 2018-17 requires a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented. When consolidating, the cumulative-effect adjustment is based on the carrying amounts of the assets, liabilities, and noncontrolling interests (or any retained interest) of the legal entity being consolidated if it is practicable to determine such carrying amounts. The Update allows a practicability exception to initially measure such carrying amounts at fair value.

Practice Point: It is possible that a reporting entity, currently applying the ASU 2014-07 private company exception not to consolidate leasing VIEs under common control, would not be eligible to apply the scope exception in ASU 2018-17. In this event, the reporting entity would be required to apply the guidance in the VIE model retrospectively.

If a reporting entity applies the new private company scope exception upon transition to ASU 2018-17 and one of the entities (the parent, reporting entity, or legal entity) subsequently becomes a PBE, the reporting entity can no longer apply the scope exception. In this event, the transition approach would depend on which entity became a PBE. If the reporting entity is not the entity that became a PBE, prospective application of the VIE guidance would be required. However, if the reporting entity is the entity that became a PBE, retrospective application of the VIE guidance would be required. Therefore, the reporting entity must continually assess whether it can continue to apply the scope exception.

Disclosures

ASU 2018-17 disclosure requirements for the PCC scope exception follow:

A reporting entity that neither consolidates nor applies the requirements of the VIE subsections to a legal entity under common control because it meets the criteria in paragraph 810-10-15-17AD shall disclose the following:

a. The nature and risks associated with a reporting entity's involvement with the legal entity under common control.

b. How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows.

c. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control.

d. The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. Disclose if the reporting entity cannot quantify its maximum exposure to loss resulting from its involvement with the legal entity under common control.

e. If the reporting entity's maximum exposure to loss (d above) exceeds the carrying amount of the assets and liabilities (c above), qualitative and quantitative information to allow users of financial statements to understand the excess exposure. Such as, the arrangement's explicit and implicit terms that could require the reporting entity to provide financial support to the legal entity under common control. This includes events or circumstances that could expose the reporting entity to a loss. An example would be guarantees to fund losses.

In applying the disclosure guidance, a reporting entity under common control shall consider exposures through implicit guarantees. Determining whether an implicit guarantee exists is based on facts and circumstances which may include whether:

- The private company reporting entity has an economic incentive to act as a guarantor or to make funds available.

- The private company reporting entity has acted as a guarantor for or made funds available to the legal entity in the past.

In disclosing information about the legal entity under common control, a private company reporting entity shall present these disclosures in addition to the disclosures required by other guidance. Examples would be ASC Topic 460 for guarantees, ASC Topic 850 for related party disclosures, and ASU Topic 842 for leases. Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

IAS 24, Related Party Disclosures

IAS 24, *Related Party Disclosures*, describes related parties as persons or entities that are related to the entity that is preparing its financial statements (known as the "reporting entity"), including:

- A person, or close member of that person's family, who controls, jointly controls, or has significant influence over, the reporting entity.
- A person, or close member of that person's family, who is part of key management personnel of the reporting entity or the reporting entity's parent.
- An entity that is a member of the same group in which the reporting entity is also a member (this implies that each parent, subsidiary, and fellow subsidiary are related to each other).
- An entity that is an associate or joint venture of the reporting entity or vice versa.
- An entity that is a member of a joint venture in which the reporting entity is a venturer.
- An entity that is a joint venture of a third entity, of which the reporting entity is an associate, and vice versa.
- An entity that is a postemployment benefit plan for the benefit of employees of the reporting entity or of an entity related to the reporting entity.

In the context of IAS 24, it should be noted than an associate includes subsidiaries of that associate, and a joint venture includes subsidiaries of that joint venture. Thus, for example, an associate's subsidiary, and the investor that has significant influence over the associate, are considered related to each other.

IAS 24 specifically excludes the following from related parties:

- Two entities simply because they have a director or key manager in common.
- Two venturers who share joint control over a joint venture.
- Providers of finance, trade unions, public utilities, and government departments and agencies that do not control, jointly control, or significantly influence the reporting entity simply as a result of their regular dealings with the reporting entity.
- A single customer, supplier, franchiser, distributor, or general agent with whom the reporting entity transacts a significant volume of business simply because of the resulting economic dependence.

Disclosures required in IAS 24 include:

- Nature of any parent-subsidiary relationships even if there have been no related party transactions.
- **Key management compensation**, in total, and for each of the following categories:
  - Short-term employee benefits;
  - Postemployment benefits;
  - Other long-term benefits;
  - Termination benefits;
  - Share-based payments.
- Description of any related party transactions such as purchases, sales, leases, guarantees, etc.
- Amounts of related party transactions during each reporting period. Amounts of any outstanding balances including details of any guarantees given or received.
- Provisions of any uncollectible receivables related to the amount of outstanding balances.
- The expense recognized during the period for bad or doubtful debts due from related parties.
- Separate disclosures should be made for each of the following:
  - The parent;
  - Entities with joint control or significant influence over the reporting entity;
  - Subsidiaries;
  - Associates;
  - Joint ventures where the reporting entity is a venturer;
  - Key management personnel of the reporting entity or its parent;
  - Other related parties.

The related party disclosures required by U.S. GAAP and IFRS are very similar except for the IFRS requirement for key management compensation disclosures.

EXAMPLE

Heineken

Notes to the Consolidated Financial Statements

13.3 RELATED PARTIES

Identification of related parties

The following parties are considered to be related to Heineken Holding N.V.:

- Its Board of Directors
- The Executive Board and Supervisory Board of Heineken N.V.
- L'Arche Green N.V.
- L'Arche Holding B.V.
- Stichting Administratiekantoor Priores
- Fomento Económico Mexicano, S.A.B. de C.V. (FEMSA)
- Associates and Joint ventures of Heineken N.V.
- HEINEKEN pension funds (refer to note 9.1)
- Employees of HEINEKEN (refer to note 6.4)

Heineken Holding N.V.'s ultimate controlling party is C.L. de Carvalho-Heineken. For the structure of the HEINEKEN Group reference is made to the Report of the Board of Directors, page 13.

Board of Directors of Heineken Holding N.V. remuneration

In thousands of €	**2018**	2017
C.L. de Carvalho-Heineken	**60**	60
M.R. de Carvalho	**60**	60
Remuneration executive members	**120**	120
M. Das	**90**	90
J.A. Fernández Carbajal	**60**	60
C.M. Kwist	**60**	60
A.A.C. de Carvalho	**60**	60
A.M. Fentener van Vlissingen[1]	**42**	—
L.L.H. Brassey[1]	**42**	—
Remuneration non-executive members	**354**	270
	474	390

[1] Appointed as at 19 April 2018

As at 31 December 2018, the Board of Directors represented 151,685,148 shares in the Company (2017:151,685,148 ordinary shares).

EXAMPLE (CONTINUED)

Executive Board of Heineken N.V.

The remuneration of the members of the Executive Board of Heineken N.V. consists of a fixed component and a variable component. The variable component is made up of a Short-term Incentive (STI) and a Long-term Incentive (LTI). The STI is based on financial and operational measures (75%) and on individual leadership measures (25%) as set by the Supervisory Board of Heineken N.V. at the beginning of the year. For the LTI refer to note 6.5.

As at 31 December 2018, J.F.M.L. van Boxmeer held 259,149 Heineken N.V. shares and L.M. Debroux held 28,159 Heineken N.V. shares (2017: J.F.M.L. van Boxmeer 240,695 and L.M. Debroux 11,829).

Executive Board of Heineken N.V. remuneration

		2018			2017	
In thousands of €	J.F.M.L. van Boxmeer	L.M. Debroux	Total	J.F.M.L. van Boxmeer	L.M. Debroux	Total
Fixed salary	1,250	735	1,985	1,200	720	1,920
Short-Term Incentive	2,730	1,147	3,877	2,736	1,173	3,909
Matching share entitlement	610	256	866	622	266	888
Long-Term Incentive	2,732	1,360	4,092	3,623	1,739	5,362
Pension contributions	873	145	1,018	858	142	1,000
Other emoluments	49	162	211	21	163	184
Total	**8,244**	**3,805**	**12,049**	9,060	4,203	13,263

The matching share entitlements for each year are based on the performance in that year. The Executive Board members receive 25% of their STV pay in (investment) shares. In addition they have the opportunity to indicate before year-end whether they wish to receive up to another 25% of their STI in (investment) shares. All (investment) shares are restricted for sale for five calendar years, after which they are matched 1:1 by (matching) shares. For 2018 the Executive Board members did not elect to receive additional (investment) shares, hence the 'Matching share entitlement' in the table above is based on a 25% investment. In 2017 the investment was 25% for both Executive Board members as well. From an accounting perspective the corresponding matching shares vest immediately and as such a fair value of €0.9 million was recognised in the 2018 income statement. The matching share entitlements are not dividend-bearing during the five calendar year holding period of the investment shares. Therefore, the fair value of the matching share entitlements has been adjusted for missed expected dividends by applying a discount based on the dividend policy and vesting period.

EXAMPLE (CONTINUED)

Supervisory Board of Heineken N.V. remuneration

The individual members of the Supervisory Board received the following remuneration:

In thousands of €	2018	2017
G.J. Wijers	163	160
J.A. Fernández Carbajal	109	114
M. Das	85	85
M.R. de Carvalho	96	90
A.M. Fentener van Vlissingen[1]	43	85
V.C.O.B.J. Navarre	74	70
J.G. Astaburuaga Sanjinés	104	99
H. Scheffers[2]	—	40
J.M. Huët	86	82
P. Mars-Wright	103	95
Y. Dervisoglu	70	70
M. Helmes[3]	62	—
	995	990

[1]Stepped down as at 19 April 2018.
[2]Stepped down as at 20 April 2017.
[3]Appointed as at 19 April 2018.

M.R. de Carvalho held 100,008 shares of Heineken N.V. as at 31 December 2018 (2017: 100,008 shares). As at 31 December 2018 and 2017, the Supervisory Board members did not hold any of the Heineken N.V. bonds or option rights. M.R. de Carvalho held 100,008 shares of Heineken Holding N.V. as at 31 December 2018 (2017: 100,008 ordinary shares).

Other related party transactions

	Associates & Joint Ventures		FEMSA		Total	
In millions of €	2018	2017	2018	2017	2018	2017
Sales	467	300	1,235	1,168	1,702	1,468
Purchases	271	479	144	168	415	647
Accounts receivables	93	88	274	238	367	326
Accounts payables and other liabilities	40	68	43	42	83	110

There are no significant transactions with L'Arche Green N.V., L'Arche Holding B.V. and Stichting Administratiekantoor Priores.

SEC – Item 404, Certain Relationships and Related Transactions

The purpose of this section is to elicit disclosure regarding transactions and relationships, including indebtedness, involving the company and related persons and the independence of directors and nominees for director and the interest of management.

Item 404 has four parts:

1. General disclosure requirements for related person transactions, including those involving indebtedness
2. Disclosure regarding the company's policies and procedures for the review, approval and ratification of related party transactions
3. Disclosures regarding promoters and certain control persons of the company
4. Corporate governance disclosure requirements and the independence of directors

This section will only address 1 and 2 above in this program.

Item 404 defines the following terms:

- **Transaction** – Includes but is not limited to, any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships. The definition also includes indebtedness and guarantees of indebtedness.
- **Related Person** – Any person who was in the following categories at any time during the three year required disclosure period:
  - Any director or executive officer of the company and his/her immediate family
  - If disclosure were provided in a proxy or information statement relating to the election of directors, any nominee for director and the immediate family of any nominee for director
- **Amount** – Dollar amount of the transaction or series of similar transactions

Disclosures required in Item 404 include:

For **related person transactions**, the company is required to describe the transaction including:

- The person's name and relationship to the company
- The person's interest in the transaction with the company, including the related person's position or relationship with, or ownership in, a firm, corporation, or other entity that is a party to or has an interest in the transaction

- The approximate dollar value of the amount involved in the transaction and of the related person's interest in the transaction
- Any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction

EXAMPLE

Sears Holdings Corporation
Notes to Consolidated Financial Statements

NOTE 15—RELATED PARTY DISCLOSURE

Mr. Lampert is Chairman of our Board of Directors and its Finance Committee and is the Chairman and Chief Executive Officer of ESL. Additionally, on February 1, 2013, Mr. Lampert became our Chief Executive Officer, in addition to his role as Chairman of the Board. ESL owned approximately 48% of our outstanding common stock at January 28, 2017 (excluding shares of common stock that ESL may acquire within 60 days upon the exercise of warrants to purchase shares of our common stock).

On February 25, 2016, Holdings announced the election of Bruce R. Berkowitz to membership on our Board of Directors. Mr. Berkowitz serves as the Chief Investment Officer of Fairholme Capital Management, LLC, an investment advisor registered with the U.S. Securities and Exchange Commission ("SEC"), and is the President and a Director of Fairholme Funds, Inc., a SEC-registered investment company providing investment management services to three mutual funds (together with Fairholme Capital Management, LLC and other affiliates, "Fairholme"). Fairholme owned approximately 26% of our outstanding common stock at January 28, 2017 (excluding shares of common stock that Fairholme may acquire within 60 days upon the exercise of warrants to purchase shares of our common stock).

Unsecured Commercial Paper

During 2016 and 2015, ESL and its affiliates held unsecured commercial paper issued by SRAC, an indirect wholly-owned subsidiary of Holdings. For the commercial paper outstanding to ESL, the weighted average of each maturity, annual interest rate, and principal amount outstanding for this commercial paper was 21 days, 7.87% and $100 million and 32 days, 4.55% and $8.8 million, respectively, in 2016 and 2015. The largest aggregate amount of principal outstanding to ESL at any time since the beginning of 2016 was $245 million and the aggregate amount of interest paid by SRAC to ESL during 2016 was $8 million.

During 2016 and 2015, Fairholme and its affiliates held unsecured commercial paper issued by SRAC. For the commercial paper outstanding to Fairholme, the weighted average of each maturity, annual interest rate, and principal amount outstanding for this commercial paper was 63 days, 7.42% and $1.3 million and 7 days, 3.70% and $4.5 million, respectively, in 2016 and 2015. The largest aggregate amount of principal outstanding to Fairholme at any time since the beginning of 2016 was $5 million and the aggregate amount of interest paid by SRAC to Fairholme during 2016 was $109 thousand.

The commercial paper purchases were made in the ordinary course of business on substantially the same terms, including interest rates, as terms prevailing for comparable transactions with other persons, and did not present features unfavorable to the Company.

Secured Short-Term Loan

In September 2014, the Company, through the Short-Term Borrowers, entities wholly-owned and controlled, directly or indirectly by the Company, entered into the $400 million Short-Term Loan with the Short-Term Lender, entities affiliated with ESL and Fairholme. The Company repaid the Short-Term Loan during 2015, resulting in no balance outstanding at January 28, 2017 or January 30, 2016. See Note 3 for additional information regarding the Short-Term Loan.

EXAMPLE (CONTINUED)

LC Facility

On December 28, 2016, the Company, through the Borrowers, entered into the LC Facility Agreement providing for the $500 million LC Facility with the Lenders, entities affiliated with ESL. On December 28, 2016, $200 million of commitments were made available under the LC Facility, and, subject to approval of the Lenders, up to an additional $300 million in commitments may be obtained by the Company from the Lenders (or other lenders) prior to December 28, 2017, the maturity date of the LC Facility. At January 28, 2017, we had $200 million of letters of credit outstanding under the LC Facility, and the Lenders maintain cash collateral on deposit with the Issuing Bank of $204 million. See Note 3 for additional information regarding the LC Facility.

2017 Secured Loan Facility

On January 3, 2017, the Company, through the 2017 Secured Loan Borrowers, obtained a $500 million real estate loan facility from the Lenders, entities affiliated with ESL. At January 28, 2017, JPP LLC and JPP II, LLC, entities affiliated with ESL, held $500 million of principal amount of the 2017 Secured Loan Facility. See Note 3 for additional information regarding the 2017 Secured Loan Facility.

2016 Secured Loan Facility

In April 2016, the Company, through the 2016 Secured Loan Borrowers, obtained a $500 million real estate loan facility from the 2016 Secured Loan Lenders, some of which are entities affiliated with ESL. At January 28, 2017, entities affiliated with ESL held $216 million of principal amount of the 2016 Secured Loan Facility. See Note 3 for additional information regarding the 2016 Secured Loan Facility.

2016 Term Loan

In April 2016, the Company, through the ABL Borrowers, obtained a $750 million senior secured term loan under the Amended Domestic Credit Agreement with a syndicate of lenders, including $146 million (net of original issue discount) from JPP, LLC and JPP II, LLC, entities affiliated with ESL, and $100 million from the Company's domestic pension plan. At January 28, 2017, JPP LLC and JPP II, LLC, and the Company's domestic pension plans held $150 million and $100 million, respectively, of principal amount of the 2016 Term Loan. See Note 3 for additional information regarding the 2016 Term Loan.

Second Lien Term Loan

In September 2016, the Company, through the ABL Borrowers, obtained a $300 million Second Lien Term Loan from the Lenders, entities affiliated with ESL. At January 28, 2017, JPP LLC and JPP II, LLC, entities affiliated with ESL, held $300 million of principal amount of the Second Lien Term Loan. See Note 3 for additional information regarding the Second Lien Term Loan.

Senior Secured Notes

At both January 28, 2017 and January 30, 2016, Mr. Lampert and ESL held an aggregate of approximately $11 million of principal amount of the Company's Senior Secured Notes. Mr. Lampert and ESL tendered approximately $165 million of the Company's Senior Secured Notes in the Offer, which is further discussed in Note 3.

At January 28, 2017 and January 30, 2016, Fairholme held an aggregate of approximately $46 million and $22 million of principal amount of the Company's Senior Secured Notes, respectively. Fairholme tendered approximately $207 million of the Company's Senior Secured Notes in the Tender Offer, which is further discussed in Note 3.

EXAMPLE (CONTINUED)

Subsidiary Notes

At both January 28, 2017 and January 30, 2016, Mr. Lampert and ESL held an aggregate of $3 million of principal amount of unsecured notes issued by SRAC (the "Subsidiary Notes").

At both January 28, 2017 and January 30, 2016, Fairholme held an aggregate of $14 million of principal amount of the Subsidiary Notes.

Senior Unsecured Notes and Warrants

At January 28, 2017 and January 30, 2016, respectively, Mr. Lampert and ESL held an aggregate of approximately $188 million and $193 million of principal amount of the Company's Senior Unsecured Notes, and 10,033,472 warrants to purchase shares of Holdings' common stock at both January 28, 2017 and January 30, 2016.

At January 28, 2017 and January 30, 2016, respectively, Fairholme held an aggregate of approximately $357 million and $360 million of principal amount of the Company's Senior Unsecured Notes, and 6,713,725 and 6,839,379 warrants to purchase shares of Holdings' common stock.

Sears Canada

ESL owns approximately 45% of the outstanding common shares of Sears Canada (based on publicly available information as of January 4, 2016). Fairholme owns approximately 20% of the outstanding common shares of Sears Canada (based on publicly available information as of November 29, 2016).

Lands' End

ESL owns approximately 59% of the outstanding common stock of Lands' End (based on publicly available information as of January 5, 2017). Fairholme owns approximately 11% of the outstanding common shares of Lands' End (based on publicly available information as of October 11, 2016). Holdings and certain of its subsidiaries entered into a transition services agreement in connection with the spin-off pursuant to which Lands' End and Holdings agreed to provide, on an interim, transitional basis, various services, including but not limited to, tax services, logistics services, auditing and compliance services, inventory management services, information technology services and continued participation in certain contracts shared with Holdings and its subsidiaries, as well as agreements related to Lands' End Shops at Sears and participation in the Shop Your Way program. The majority of the services under the transition services agreement with Lands' End have expired or been terminated.

Amounts due to or from Lands' End are noninterest bearing, and generally settled on a net basis. Holdings invoices Lands' End on at least a monthly basis. At both January 28, 2017 and January 30, 2016, Holdings reported a net amount payable to Lands' End of $1 million in other current liabilities in the Consolidated Balance Sheets. Amounts related to revenue from retail services and rent for Lands' End Shops at Sears, participation in the Shop Your Way program and corporate shared services were $65 million, $69 million and $63 million, respectively, during 2016, 2015 and 2014. The amounts Lands' End earned related to call center services and commissions were $10 million, $10 million and $9 million, respectively, during 2016, 2015 and 2014.

SHO

ESL owns approximately 57% of the outstanding common stock of SHO (based on publicly available information as of December 1, 2016). Holdings and certain of its subsidiaries engage in transactions with SHO pursuant to various agreements with SHO which, among other things: (1) govern the principal transactions relating to the rights offering and certain aspects of our relationship with SHO following the separation; (2) establish terms under which Holdings and certain of its subsidiaries will provide SHO with services; and (3) establish terms pursuant to which Holdings and certain of its subsidiaries will obtain merchandise for SHO.

EXAMPLE (CONTINUED)

These agreements were made in the context of a parent-subsidiary relationship and were negotiated in the overall context of the separation. A summary of the nature of related party transactions involving SHO is as follows:

- SHO obtains a significant amount of its merchandise from the Company at cost. We have also entered into certain agreements with SHO to provide logistics, handling, warehouse and transportation services. SHO also pays a royalty related to the sale of Kenmore, Craftsman and DieHard products and fees for participation in the Shop Your Way program.
- SHO receives amounts from the Company for the sale of merchandise made through www.sears.com, extended service agreements, delivery and handling services and credit revenues.
- The Company provides SHO with shared corporate services. These services include accounting and finance, human resources, information technology and real estate.

Amounts due to or from SHO are noninterest bearing, settled on a net basis, and have payment terms of 10 days after the invoice date. The Company invoices SHO on a weekly basis. At January 28, 2017 and January 30, 2016, Holdings reported a net amount receivable from SHO of $81 million and $51 million, respectively, within accounts receivable in the Consolidated Balance Sheets. Amounts related to the sale of inventory and related services, royalties, and corporate shared services were $1.2 billion, $1.5 billion and $1.6 billion, respectively, during 2016, 2015 and 2014. The net amounts SHO earned related to commissions were $82 million, $91 million and $99 million, respectively, during 2016, 2015 and 2014. Additionally, the Company has guaranteed lease obligations for certain SHO store leases that were assigned as a result of the separation. See Note 4 for further information related to these guarantees.

Also in connection with the separation, the Company entered into an agreement with SHO and the agent under SHO's secured credit facility, whereby the Company committed to continue to provide services to SHO in connection with a realization on the lender's collateral after default under the secured credit facility, notwithstanding SHO's default under the underlying agreement with us, and to provide certain notices and services to the agent, for so long as any obligations remain outstanding under the secured credit facility.

Seritage

ESL owns approximately 7.9% of the total voting power of Seritage, and approximately 43.5% of the limited partnership units of Seritage Growth Properties, L.P. (the “Operating Partnership”), the entity that now owns the properties sold by the Company in the Seritage transaction and through which Seritage conducts its operations (based on publicly available information as of August 14, 2015). Mr. Lampert is also currently the Chairman of the Board of Trustees of Seritage. Fairholme owns approximately 14% of the outstanding Class A common shares of Seritage and 100% of the outstanding Class C nonvoting common shares of Seritage (based on publicly available information as of February 16, 2016).

In connection with the Seritage transaction as described in Note 11, Holdings entered into a Master Lease agreement with Seritage. The initial amount of aggregate annual base rent under the Master Lease is $134 million for the REIT properties, with increases of 2% per year beginning in the second lease year. At January 30, 2016, Holdings reported prepaid rent of $9 million in prepaid expenses and other current assets in the Consolidated Balance Sheet. Holdings recorded rent expense of $83 million and $49 million in cost of sales, buying and occupancy for 2016 and 2015, respectively. Rent expense consists of straight-line rent expense of $142 million and $84 million, offset by amortization of a deferred gain recognized pursuant to the sale and leaseback of properties from Seritage of $59 million and $35 million for 2016 and 2015, respectively.

EXAMPLE (CONTINUED)

In addition to base rent under the Master Lease, Holdings pays monthly installment expenses for property taxes and insurance at all REIT properties where Holdings is a tenant and installment expenses for common area maintenance, utilities and other operating expenses at REIT properties that are multitenant locations where Holdings and other third parties are tenants. The initial amount of aggregate installment expenses under the Master Lease was $70 million, based on estimated installment expenses, and currently is $52 million as a result of reconciling actual installment expenses and recapture activity. Holdings paid $64 million and $40 million for 2016 and 2015, respectively, recorded in cost of sales, buying and occupancy.

At January 28, 2017 and January 30, 2016, Holdings reported an amount receivable from Seritage of $14 million and $7 million, respectively, in accounts receivable in the Consolidated Balance Sheets. Holdings reported an amount payable to Seritage of $11 million in other current liabilities in the Consolidated Balance Sheets at January 28, 2017.

Holdings and Seritage entered into a transition services agreement pursuant to which Holdings will provide certain limited services to Seritage for up to 18 months. The services include specified facilities management, accounting, treasury, tax, information technology, risk management, human resources, and related support services. Under the terms of the transition services agreement, the scope and level of the facilities management services will be substantially consistent with the scope and level of the services provided in connection with the operation of the transferred properties held by Holdings prior to the closing of the Seritage transaction. The majority of the services under the transition services agreement with Seritage have expired or have been terminated. Amounts due from Seritage are generally settled on a net basis. Holdings invoices Seritage on at least a monthly basis. Revenues recognized related to the transition services agreement were not material for 2016 or 2015.

For disclosures regarding the **company's policies and procedures** for the review, approval and ratification of related party transactions, Item 404 requires:

- A description of the material features of the company's policies and procedures for the review, approval, or ratification of transactions with related persons. These material features should include:
  - The types of transactions that are covered by such policies and procedures, and the standards to be applied pursuant to such policies and procedures
  - The persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures
  - Whether such policies and procedures are in writing and, if not, how such policies and procedures are communicated

An example of Citi's Policy on Related Party Transactions can be found in Appendix A of this program.

In May 2019 at the SEC's request, the FASB proposed adding interim and annual disclosure requirements to many topics. Although requested by the SEC, the FASB's proposal would apply to all entities.

The FASB's proposal for increased related party disclosures will apply only to public companies. It would require additional disclosures of profits and losses resulting from transactions with other consolidated entities and the effect of these transactions on the financial statements.

AUDITING CONSIDERATIONS

Introduction

Related party auditing guidance can primarily be found in two documents:

1. ASB's and the IAASB's AU-C/ISA Section 550, *Related Parties*

2. PCAOB's AS 18, *Related Parties*

AU-C/ISA Section 550, Related Parties

The auditor has the responsibility to perform audit procedures to identify, assess, and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions, or balances. The auditor must also develop an understanding of the entity's related party relationships and transactions to comply with the requirements in AU-C 240, *Consideration of Fraud in a Financial Statement Audit,* to evaluate whether one or more fraud risk factors exist since related parties are a fraud risk factor.

The **objectives** of the auditor in this section are to:

- Obtain an understanding of related party relationships and transactions sufficient to be able to:

  - Recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the **risks of material misstatement due to fraud**

  - Conclude, based on the audit evidence obtained, whether the financial statements, considering related party relationships and transactions, **present fairly**

- Obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for, and disclosed in the financial statements.

The **requirements** in this section are organized in the following areas:

1. **Risk Assessment Procedures and Related Activities:**

   - The auditor should **inquire** of management regarding the following:

     – The identity of the entity's related parties, including changes from the prior period

     – The nature of the relationships between the entity and those related parties

     – Whether the entity entered into any transactions with these related parties during the period, and, if so, the type and purpose of the transactions

   - The auditor should also **inquire** of management and others and perform other risk assessment procedures considered appropriate to obtain an understanding of the controls, if any, that management has established to:

     – Identify, account for, and disclose related party relationships and transactions

     – Authorize and approve significant transactions and arrangements with related parties

     – Authorize and approve significant transactions and arrangements outside the normal course of business

   - In addition, the auditor should **maintain alertness** for related party information when reviewing third-party evidence or entity records or documents

2. **Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions:**

   - Identified significant related party transactions **outside the entity's normal course of business** are to be treated as significant audit risks

   - If the auditor identified **related party fraud risk factors**, these factors should be considered when evaluating the risk of material misstatement due to fraud

3. **Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions:**

   - If the auditor identifies related parties or significant related party transactions that management has **not previously identified or disclosed** to the auditor, the auditor should:

     – Immediately communicate the relevant information to the other members of the engagement team

- Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation
- Inquire why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions
- Perform appropriate substantive audit procedures relating to the newly discovered related parties or significant related party transactions
- Reconsider the risk that other related parties or significant related party transactions may exist and perform additional audit procedures as necessary
- Evaluate the implications for the audit if the nondisclosure by management appears intentional and suggests an increased risk of material misstatement due to fraud

- For significant related party transactions **outside the entity's normal course of business**, the auditor should:
  - Inspect the underlying contracts or agreements, if any, evaluating the business rationale, if any, of the transactions; the terms of the transactions; and whether the transactions have been appropriately accounted for and disclosed
  - Obtain audit evidence that the transactions have been appropriately authorized and approved

4. **Evaluation of the Accounting for, and Disclosure of, Identified Related Party Relationships and Transactions:**

   - In forming an opinion on the financial statements, the auditor should evaluate the following:
     - Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed
     - Whether the effects of the related party relationships and transactions prevent the financial statements from being fairly presented

5. **Communication with those Charged with Governance.** This includes significant findings and issues arising during the audit in connection with the entity's related parties.

6. **Documentation** should include the names of the identified related parties and the nature of the related party relationships.

Note: There is no current requirement in the audit literature for the auditor to seek out and identify undisclosed related parties. This suggests that the possibility of the existence of undisclosed related parties is a fraud risk that must be considered by the audit engagement team.

Triggers That May Indicate a Related Party Transaction

The following are examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;
- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business;
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions);
- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;

- Disclosures contained on the company's website;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;
- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.

PCAOB – AS 18 (now codified as AS 2410), Related Parties

AS 18 establishes requirements regarding the auditor’s evaluation of a company’s relationships and transactions between the company and its related parties. The auditor’s **objective** is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. This objective is not different than the objective described in AU-C/ISA Section 550.

AS 18 has been added to this program due to the perception of many that PCAOB standards will eventually be added to the performance requirements for nonpublic audits in the future. Auditing is auditing and to have different standards for public and nonpublic audits is not in the public interest.

The **requirements** in this section are organized in the following areas (Note: These requirements are organized the same as AU-C/ISA Section 550 but the specific procedures are enhanced from those required for nonpublic company audits.):

1. **Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with its Related Parties:**

   - Obtaining an **Understanding of Internal Control over Financial Reporting**, the auditor should obtain an understanding of the company's process:

     – Identifying related parties and relationships and transactions with related parties

     – Utilizing and approving transactions with related parties

     – Accounting for and disclosing relationships and transactions with related parties in the financial statements

   - **Performing Inquiries of Management**. The auditor should inquire of management regarding:

     – The names of the company's related parties during the period under audit, including changes from the prior period

     – Background information concerning the related parties

     – The nature of any relationships, including ownership structure between the company and its related parties

     – The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (if any) of such transactions

     – The **business purpose** for entering into a transaction with a related party versus an unrelated party

     – Any related party transactions that have not been authorized and approved in accordance with the company's established policies and procedures (SEC Item 404) regarding the authorization and approval of transactions with related parties

     – Any related party transactions for which exceptions to the company's established policies or procedures (SEC Item 404) were granted and the reasons for granting those exceptions

- **Performing Inquiries of Others**. The auditor should inquire of others regarding:
  - The company's related parties or relationships or transactions with related parties
  - The company's controls over relationships or transactions with related parties
  - The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor
- **Communicating** with the Audit Engagement Team and Other Auditors. The auditor should communicate to engagement team members' relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.

2. **Identifying and Assessing Risks of Material Misstatement** at the financial statement level and at the assertion level for related party relationships and transactions.
3. **Responding to the Risks of Material Misstatement** by designing and performing audit procedures that address the risks of material misstatement associated with related parties and relationships and transactions with related parties.
   - For each related party transaction that is either **required to be disclosed in the financial statements or determined to be a significant risk**, the auditor should:
     - Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose, if any, of the transaction
     - Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures (SEC Item 404) regarding the authorization and approval of transactions with related parties
     - Determine whether any exceptions to the company's established policies or procedures (SEC Item 404) were granted
     - Evaluate the **financial capability** of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations – THIS IS A SIGNIFICANT DIFFERENCE FOR NONPUBLIC COMPANY AUDIT STANDARDS
     - Perform other procedures as necessary to address the identified and assessed risk of material misstatement

4. **Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties.** This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

   - If the auditor determines that a related party or relationship or transaction with a related party previously **undisclosed to the auditor** exists, the auditor should:

     – Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor

     – Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor

     – Immediately communicate to appropriate member of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party

     – Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor

     – Perform the procedures required in part 3 of the requirements above for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk

     – In addition, perform the following procedures:

       - Evaluate the implications on the auditor's assessment of internal control over financial reporting

       - Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in higher risk

       - Evaluate the implications for the audit if management's nondisclosure to the auditor indicates that fraud or illegal acts may have occurred

5. **Evaluating Financial Statement Accounting and Disclosure.** This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with GAAP.

6. **Communications with the Audit Committee.** This includes significant findings and issues arising during the audit in connection with the company's related parties.

AICPA PRACTICE AID – ACCOUNTING AND AUDITING FOR RELATED PARTIES AND RELATED PARTY TRANSACTIONS

Introduction

This practice aid was created because related parties, such as controlled entities, principal stockholders or management can execute transactions that improperly inflate/deflate earnings by masking their economic substance or distort reported results through lack of disclosure, or can even defraud a company by transferring funds to conduit related parties that benefit fraudsters.

While this practice aid addresses many of the accounting and auditing issues previously discussed in this program, it also identifies **related party indicators** that if present, should alert auditors and others to the possible existence of undisclosed material related party relationships or transactions. These related party indicators include the following:

- **Agreements under which one party pays expenses on behalf of another party** – When these situations occur, the expenses paid for by the related party may not be passed through to the company resulting in understated expenses on the company's financial statements. If these payments are discovered, they are likely indicative of the existence of an undisclosed related party.

- **Circular arrangements between related parties** – Sales transactions in which the seller has agreed to buy goods or services from the customer as part of the sale arrangement. It would be unlikely that nonrelated parties would participate in a transaction of this type, indicating that these types of transactions are normally with a related party.

- **Engaging in business deals (such as leases or asset sales) at more or less than market value** – Independent (nonrelated parties) transactions would always be at existing fair market values and when transactions are at amounts above or below fair market values this is normally indicative of related party transactions.

- **Identification of an undisclosed related party** – The identification of one undisclosed related party increases the risk that other undisclosed related parties may exist. Auditors and others will need to assess whether management's failure to disclose the existence of this related party was a deliberate attempt to hide the relationship and if so, what impact this failure to disclose has on the fair presentation of the financial statements considering there may be other undisclosed related parties.

- **Payments for services at inflated prices** – This can occur when an undisclosed related party is a supplier or vendor and there exists a collusive agreement between management and the supplier or vendor. When an evaluation of supplier or vendor pricing indicates that prices charged are above market prices, this may be indicative of the existence of an undisclosed related party.

- **Improper revenue recognition** – Improper revenue recognition is a significant fraudulent activity existing in more than half of all identified frauds. Management, with the cooperation of a related party, may participate in sales transactions that overstate or understate revenue in order to achieve preexisting goals or objectives. These transactions do not reflect the economic substance of the transaction and if not properly identified, misrepresent the financial statement results.

- **Sales without substance** – Borrowings made by a related party guaranteed by the company and then those borrowings transferred to the company recorded as sales. If the related party is undisclosed, these transactions may appear reasonable and lead to misleading financial statements.

- **Unusual or material transactions, particularly at or close to year end** – Many of related party frauds occur towards the end of the fiscal period when it becomes apparent to management/owners that the company will not achieve certain performance results. Using related parties to improve the financial position of the company by overstating revenue and earnings at the end of the year is a common occurrence. Auditors and others must identify transactions of this type to determine if undisclosed related parties exist.

- **Utilization of a related party to mitigate market risks** – This occurs through the creation of an off balance sheet shell company to hide losses or additional borrowings and not consolidating this shell company into the company's financial statements. If an off balance sheet shell company is discovered, this would be an undisclosed related party.

CONCLUSION

Related party accounting and auditing guidance is extensive reflecting the risks associated with related party transactions as well as the existence of undisclosed related parties. While auditors and others are not required to seek out and identify undisclosed related parties, it is recommended that any transaction that appears unusual or unexpected be evaluated for the possibility that that transaction reflects the **form and not the substance** of the arrangement.

Disclosing related party transactions does not eliminate the need to consider whether the accounting treatment is consistent with the underlying substance of the activity. At times, disclosure is thought by some to mitigate the need for proper accounting and this is not true. The substance of the arrangement must be accounted for properly as well as the related disclosures.

APPENDIX A

Policy on Related Party Transactions

OWNER: *CITIGROUP CORPORATE LAW DEPARTMENT OFFICE OF THE GENERAL COUNSEL*

CONTACT: *GENERAL COUNSEL, CORPORATE GOVERNANCE*

ISSUE DATE: *JANUARY 2007*

REVISED: *JANUARY 2017*

1 - Overview

1.1 - Objective

Citigroup Inc. (the "Company" or "Citi") has adopted this Policy on Related Party Transactions (the "Policy"), as required by Item 404(b) of Regulation S-K of the Securities Act of 1933 (the "Act").

The Policy applies to any transaction where the aggregate amount involved will or may be expected to exceed $120,000 in any fiscal year, the Company is a participant, and a Related Person has or will have a direct or indirect material interest, unless the transaction is exempt under Section 3 of this Policy. The Policy may be amended at any time and is subject to further guidance from the SEC and/or actions taken by the Company's Board of Directors (the "Board") or the Board's Nomination, Governance and Public Affairs ("NGPA") Committee.

1.2 - Definitions

Related Party Transaction: Any financial transaction, arrangement or relationship in which (a) the aggregate amount involved will or may be expected to exceed $120,000 in any fiscal year, (b) the Company or one its subsidiaries is a participant, and (c) any Related Person has or will have a direct or indirect material interest.

Related Person: A Director (including a nominee), Senior Manager, 5% Shareholder, Immediate Family Member or Primary Business Affiliation.

Senior Manager: Any individual who has been appointed an officer of the Company for purposes of Section 16 of the Act and/or who is a member of the Company's Operating Committee.

Director: Any member of the Board who is not also a Senior Manager.

Immediate Family Member: Any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of a Director or Senior Manager, or of a 5% Shareholder if such Shareholder is a natural person, and any individual (other than a tenant or an employee) sharing the household of such person.

5% Shareholder: Any person who has filed a Schedule 13D or Schedule 13G with the SEC reporting ownership of 5% or more of the Company's common stock or securities convertible into the Company's common stock.

Primary Business Affiliation: Any entity (other than Citi) of which a Director or Senior Manager or a 5% Shareholder if such Shareholder is a natural person, or an Immediate Family Member of such an individual, is an officer, partner or employee or in which the Director, Senior Manager or Immediate Family Member owns directly or indirectly at least a 5% equity interest.

1.3 - Owner

The Policy was adopted by the NGPA Committee. Any changes to the Policy must be approved by the NGPA Committee. The Corporate Governance unit of Citigroup's Corporate Law Department is responsible for updating this Policy as needed.

Questions about the Policy and its application to Related Persons or their Immediate Family Members, should be directed to the General Counsel, Corporate Governance, at (212) 793-7396.

1.4 - Effective Date / Transition Period

This Policy is effective immediately.

1.5 - Exceptions

Any exceptions to the Policy must be consistent with the Act, including any regulations promulgated thereunder, and must be approved in advance by Citigroup's General Counsel.

2 - Procedures

2.1 - Notification of Related Party Transactions

Each Director and Senior Manager shall promptly notify the General Counsel of any material interest that such person or an Immediate Family Member of such person had, has or may have in a Related Party Transaction. The notice shall include a description of the transaction and the aggregate dollar amount.

If the Related Party Transaction involves a Director, a Senior Manager, or a 5% Shareholder or an Immediate Family Member and is valued at $50 million or more and is not exempt under Section 3 hereof, then the General Counsel shall promptly notify the Chair of the NGPA Committee of the Board. If the Related Party Transaction involves a Senior Manager (or an Immediate Family Member of a Senior Manager) and is valued at less than $50 million and is not pre- approved under Section 3 hereof, then the General Counsel shall notify the Transaction Review Committee (the “TRC”). Members of the TRC shall include the following officers of the Company, or their designees: President; General Counsel; Chief Financial Officer; Chief Compliance Officer; Chief Risk Officer; and Head of Human Resources. The TRC will report to the NGPA Committee on any Related Party Transactions it reviews below the $50 million threshold.

2.2 - Review of Related Party Transactions

The NGPA Committee shall be responsible for the review, approval or ratification of the following Related Party Transactions:

- Any Related Party Transaction in which a Director, an Immediate Family Member of a Director, a 5% Shareholder, or if such 5% Shareholder is a natural person, an Immediate Family member of such 5% Shareholder has a material interest.

- Any Related Party Transaction with a value of $50 million or more in which a Senior Manager or an Immediate Family Member of a Senior Manager has a material interest.

If advance notice of a Related Party Transaction has been given to the Chair of the NGPA Committee and it is not possible to convene a meeting of the NGPA Committee, then the Chair of the NGPA Committee shall consider whether the Related Party Transaction is appropriate and, if so, shall approve the Related Party Transaction. The NGPA Committee will be asked to ratify the Related Party Transaction at the NGPA Committee’s next regularly scheduled meeting.

No Director shall participate in any discussion or approval of a Related Party Transaction for which he or she or any member of his or her Immediate Family Member is a Related Person, except that the Director shall provide all material information concerning the Related Party Transaction to the NGPA Committee.

The TRC shall be responsible for the review, approval or ratification of a Related Party Transaction involving a Senior Manager or an Immediate Family Member of a Senior Manager, provided that the Related Party Transaction is valued at less than $50 million.

The TRC shall provide a summary to the NGPA Committee of each Related Party Transaction it approves.

2.3 - General Criteria for Approving Related Party Transactions

In determining whether to approve, ratify, disapprove or reject a Related Party Transaction, the NGPA Committee or the TRC, as appropriate, shall take into account, among other factors it deems appropriate, whether the Related Party Transaction is entered into on terms no less favorable to the

Company than terms generally available to an unaffiliated third-party under the same or similar circumstances; the results of an appraisal, if any; whether there was a bidding process and the results thereof; review of the valuation methodology used and alternative approaches to valuation of the transaction; and the extent of the Related Person's interest in the transaction. The NGPA Committee will review the following information when assessing a Related Party Transaction:

- The terms of such transaction;
- The Related Person's interest in the transaction;
- The purpose and timing of the transaction;
- Whether the Company is a party to the transaction, and if not, the nature of the Company's participation in the transaction;
- If the transaction involves the sale of an asset, a description of the asset, including date acquired and costs basis;
- Information concerning potential counterparties in the transaction;
- The approximate dollar value of the transaction and the approximate dollar value of the Related Person's interest in the transaction;
- Description of any provisions or limitations imposed as a result of entering into the proposed transaction;
- Whether the proposed transaction includes any potential reputational risk issues that may arise as a result of or in connection with the proposed transaction; and
- Any other relevant information regarding the transaction.

Senior Managers and Immediate Family Members who share a Senior Manager's household may not invest in partnerships or other investment opportunities sponsored, or otherwise made available, by the Company unless their participation is approved in accordance with this Policy. Such approval shall not be required if the investment opportunity: (i) is offered to qualified employees and investment by Senior Managers is approved by the Personnel and Compensation Committee; (ii) is made available to a Senior Manager actively involved in a business unit, the principal activity of which is to make such investments on behalf of the Company, and is offered pursuant to a co-investment plan approved by the Personnel and Compensation Committee; or (iii) is offered to Senior Managers on the same terms as those offered to qualified persons who are not employees of the Company.

Except with the approval of the NGPA Committee, no Director or Senior Manager may invest in a third-party entity if the investment opportunity is made available to him or her as a result of such individual's status as, respectively, a Director or a Senior Manager of the Company.

No Director or Immediate Family Member who shares the Director's household or is financially dependent on the Director shall receive an IPO allocation from a broker-dealer, including broker/dealers not affiliated with the Company.

2.4 - Related Party Transactions Not Approved Under This Policy

In the event the Company becomes aware of a Related Party Transaction with a Related Person that has not been approved under this Policy prior to its consummation, the matter shall be reviewed either by the TRC or the NGPA Committee, as appropriate. The TRC or the NGPA Committee shall consider all of the relevant facts and circumstances regarding the Related Party Transaction, including the items listed in Section 2.3 above, and shall evaluate all options available to the Company, including ratification, revision or termination of the Related Party Transaction. The TRC or the GPA Committee shall also examine the facts and circumstances pertaining to the failure of reporting such Related Party Transaction to the appropriate committee under this Policy, and shall take any such action it deems appropriate.

3 - Pre-Approved Related Party Transactions

The NGPA Committee has determined that each of the types of Related Party Transactions listed below shall be deemed to be preapproved or ratified, even if the aggregate amount involved exceeds $120,000 and shall not require review or approval by the NGPA Committee or the TRC.

a. *Employment of Senior Managers.* Any employment by the Company of a Senior Manager of the Company if:

   i. the related compensation is required to be reported in the Company's proxy statement under Item 402 of SEC's compensation disclosure requirements (generally applicable to "named executive officers") and such information is reported; or

   ii. the Senior Manager is not an Immediate Family Member of another Senior Manager or Director of the Company and the related compensation would be reported in the Company's proxy statement under Item 402 of the SEC's compensation disclosure requirements if the Senior Manager was a "named executive officer," and the Personnel and Compensation Committee of the Board approved (or recommended that the Board approve) such compensation.

b. *Director compensation.* Any compensation paid to a Director, if the related compensation is required to be reported in the Company's proxy statement under Item 402 of the SEC's compensation disclosure requirements.

c. *Certain transactions with other companies.* Any transaction with another company at which a Related Person's (other than a Director's or 5% Shareholder who is a natural person's) only relationship is as (i) an employee (i.e., the Related Person is not the equivalent of a Senior Manager), (ii) a beneficial owner of less than 10% of that company's outstanding equity, or (iii) in the case of partnerships, a limited partner, if the aggregate amount involved does not exceed the greater of $1,000,000 or 2 percent of that company's total annual revenues.

d. *Ordinary course transactions.*

- Any financial services, including brokerage services, banking services, loans, insurance services and other financial services, provided by the Company to any Related Person, provided, with respect to (i) a Director or his or her Immediate Family Member or (ii) a 5% Shareholder or his or her Immediate Family Member, if applicable, that the services are on substantially the same terms as those prevailing at the time for comparable services provided to nonaffiliates.

- Personal loans made or maintained by the Company to a Director, a Senior Manager or an Immediate Family Member who shares any such person's household, only if the loan: (a) is made in the ordinary course of business of the Company or one of its subsidiaries, is of a type that is generally made available to the public, and is on market terms, or terms that are no more favorable than those offered to the general public; (b) complies with applicable law, including the Sarbanes-Oxley Act of 2002 and Regulation O of the Board of Governors of the Federal Reserve; (c) when made does not involve more than the normal risk of collectibility or present other unfavorable features; and (d) is not classified by the Company as Substandard (II) or worse, as defined by the Office of the Comptroller of the Currency (OCC) in its "Rating Credit Risk" Comptroller's Handbook.

- All business relationships, lending relationships, deposit and other banking relationships between the Company and (i) a Related Person's Primary Business Affiliation or (ii) a 5% Shareholder that is not a natural person made in the ordinary course of business and on substantially the same terms as those prevailing at the time for comparable transactions with nonaffiliated persons.

- Loans made or maintained by the Company to (i) a Related Person's Primary Business Affiliation or (ii) a or 5% Shareholder that is not a natural person, only if the loan: (a) is made in the ordinary course of business of the Company or one of its subsidiaries, is of a type that is generally made available to other customers, and is on market terms, or terms that are no more favorable than those offered to other customers; (b) complies with applicable law, including the Sarbanes-Oxley Act of 2002, Regulation O of the Board of Governors of the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) Guidelines; (c) when made does not involve more than the normal risk of collectibility or present other unfavorable features; and (d) is not classified by the Company as Substandard (II) or worse, as defined by the Office of the Comptroller of the Currency (OCC) in its "Rating Credit Risk" Comptroller's Handbook.

e. *Certain Company charitable contributions.* Any charitable contribution, grant or endowment by the Company or the Citi Foundation to a charitable organization, foundation or university where a Related Person other than a 5% shareholder that is not a natural person is an employee, if the aggregate amount involved does not exceed the lesser of $1,000,000 or 2 percent of the charitable organization's total annual receipts.

f. *Transactions where all shareholders receive proportional benefits.* Any transaction where the Related Person's interest arises solely from the ownership of the Company's common stock and all holders of the Company's common stock received the same benefit on a pro rata basis (e.g., dividends).

g. *Regulated transactions.* Any transaction with a Related Person involving the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority.

h. *Certain banking-related services.* Any transaction with a Related Person involving services as a bank depositary of funds, transfer agent, registrar, trustee under a trust indenture, or similar services.

APPENDIX B

Related Party Transactions Checklist

Client:	
Period:	

Introduction

Related party/parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions.

		W/P Ref	***Initial***
	System Evaluation		
1	Determine and evaluate the client's procedures, if any, for authorizing, identifying, and properly accounting for related party transactions. Document our assessment as to whether or not significant RPTs would be identified by the procedures.		
2	Determine and evaluate the client's procedures, if any, for prohibiting individual directors or other members of management from exercising significant influence over transactions in which that person is a related party.		
	Related Parties		
3a	Obtain from management personnel (or prepare) a list of all related parties and compare with the previous year's list and the shareholder's records. Distribute the list of related parties to all staff assigned to the engagement for their consideration while performing various audit tests and attach a copy to this checklist.		
3b	If a coordinating office, distribute the list of RPTs to other offices/firms of auditors participating in the engagement.		
4a	If secondary auditors, consider obtaining representation from parent company management as to the existence of related parties.		
4b	Consider inquiring of predecessor auditors, or other firms involved in the audit, as to their knowledge of RPTs.		
5	Document any affiliations, directors, or senior management have with other entities.		

		W/P Ref	Initial
	Related Party Transactions		
6	Inquire of appropriate management personnel whether there were any transactions with related parties (including significant transactions that occurred but were not given accounting recognition).		
7	Perform procedures to identify additional related parties and significant, unusual, or nonrecurring transactions or balances involving related parties. Such procedures could include:		
	(a) identifying major customers, suppliers, borrowers, and lenders, and significant changes to these relationships		
	(b) review of lawyer billings		
	(c) review of bank guarantees		
	(d) review of contract awards		
	(e) review of overdue receivables or payables		
	(f) review of investment transactions		
	(g) transactions at, or near, the year end (refer to audit manual para 5.8.1)		
	(h) review of transactions with unusual terms of trade		
	(i) consider where RPTs may have occurred but not changed		
8	Where RPTs have been identified, prepare (or obtain) a schedule, or a summary where appropriate of these, and obtain an understanding of the business purpose of the transaction(s).		
	(a) examine invoices, agreements, etc.		
	(b) examine approval for the transaction both by management and local shareholders		
	(c) obtain confirmation of any outstanding balances		
	(d) obtain information as to the financial standing of the related parties		
	(e) indicate whether disclosure is required or not		
	(f) agree with management		

		W/P Ref	Initial
9	Where it is uncertain if the transaction is a RPT or not, consider:	______	______
	(a) obtaining confirmation of significant information directly from third parties	______	______
	(b) obtaining further information and references on supplies or customers	______	______

Signed ______________________________ Date: __________

Partner / Manager ______________________________ Date: __________

NOTES

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	Tax

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