



NZ ACCOUNTING
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EXPLANATORY GUIDE A9 FINANCIAL REPORTING BY NOT-FOR-PROFIT ENTITIES: IDENTIFYING RELATIONSHIPS FOR FINANCIAL REPORTING PURPOSES (EG A9)

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This Explanatory Guide provides guidance for not-for-profit entities in determining whether a reporting entity has a relationship with another entity for financial reporting purposes and, if so, the nature of that relationship for the purpose of accounting for that relationship in the reporting entity's financial statements prepared in compliance with standards issued by the External Reporting Board or its sub-Board, the New Zealand Accounting Standards Board.

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Introduction

1. The objective of this Explanatory Guide is to help not-for-profit (NFP) entities that are required to prepare financial statements that comply with generally accepted accounting practice (GAAP)¹ to determine whether the reporting entity has a relationship with another entity for financial reporting purposes. If such a relationship exists, the nature of that relationship needs to be determined so that it can be accounted for in the financial statements of the reporting entity.
2. This Explanatory Guide was developed to explain the types of relationships that exist between entities for financial reporting purposes. If a NFP reporting entity thinks, after reading this document, that it might have a relationship with another entity for financial reporting purposes, the entity should go to the relevant PBE Standard for further guidance in making its decision. A NFP entity applying the Tier 3 Standard, *Public Benefit Entity Simple Format Reporting - Accrual (Not-For-Profit)*, is also required to go to the relevant PBE Standard for further guidance.
3. The objective of financial statements is to provide information about the entity that is useful to a wide range of users for accountability and decision-making purposes. (See paragraph 7 of Explanatory Guide A8 *Financial Reporting by Not-for-Profit Entities: The Reporting Entity* (EG A8)). An entity that is required to prepare financial statements that comply with GAAP is a reporting entity.
4. The financial statements of a reporting entity should reflect all the activities and transactions of that entity, including the activities and transactions of some other entities with which the reporting entity has a relationship for financial reporting purposes.
5. When preparing financial statements, a reporting entity is required to:
 - (a) Determine the activities and transactions that should be included in those financial statements;
 - (b) Identify other entities with which it has a relationship for financial reporting purposes; and
 - (c) Where such a relationship exists, identify the nature of that relationship in order to account for the other entity appropriately in those financial statements.
6. Guidance for NFP entities on determining the activities and transactions that should be included in the reporting entity's financial statements is found in EG A8.

Identify Other Entities with which the Reporting Entity has a Relationship for Financial Reporting Purposes

7. PBE Standards contain requirements for the preparation of financial statements.
8. PBE Standards use the terms 'control', 'joint control' and 'significant influence' to describe a relationship that a reporting entity has with another entity for financial reporting purposes. The relationship depends on the extent to which the reporting entity is able to direct/influence the use of the resources and benefits derived from the activities of the other entity. This ability to direct/influence the use of the resources and benefits derived from the activities of another entity is often met by the reporting entity having the ability to govern, to some extent, the financial and operating policies of the other entity. This is because the benefits derived are usually the result of the financial and operating policies applied by an entity.

The Nature of a Relationship for Financial Reporting Purposes

9. Once a reporting entity has determined that it has a relationship with another entity for financial reporting purposes, it is necessary to consider the nature of that relationship and the appropriate accounting for that relationship in the reporting entity's financial statements. Determining the nature of this relationship for financial reporting purposes requires the application of judgement in the context of the particular circumstances of each entity. This is because relationships for financial reporting purposes arise in a variety of ways and the underlying circumstances differ.
10. Legal form may determine or affect the nature of relationships between entities for financial reporting purposes. However, relationships for financial reporting purposes can be created under any arrangement or mechanism and they are not restricted to relationships that arise through legal ownership. Therefore, in

¹ Generally accepted accounting practice is defined in section 8 of the Financial Reporting Act 2013 as compliance with applicable financial reporting standards and an authoritative notice if there is no provision in a financial reporting standard for the particular matter.

assessing the nature and extent of relationships between entities for financial reporting purposes, it is essential to consider the substance of the relationship.

11. The nature of a reporting entity's relationship with another entity for financial reporting purposes is likely to fall into one of the following four categories:
 - *Control relationship;*
 - *Joint control relationship;*
 - *Significant influence relationship; or*
 - *Other relationship.*
12. The way in which a reporting entity accounts for the above relationships varies to reflect the substance of the particular relationship.

Control Relationship

13. Control for financial reporting purposes is different from control as defined in legislation. Control is defined in the Companies Act 1993 in the context of a company having the power to appoint or remove all or a majority of the directors of another company². Control for financial reporting purposes can be achieved in ways other than the appointment or removal of all or a majority of the members of the governing body. Appendix A of PBE IPSAS 6 *Consolidated Financial Statements* (Not-for-profit) (PBE IPSAS 6 (NFP)) contains Application Guidance to assist a reporting entity in determining whether, for financial reporting purposes, it controls another entity.
14. Only one reporting entity can have a control relationship with another specific entity for financial reporting purposes (joint control is discussed below). PBE Standards refer to this type of relationship as 'control': the reporting entity (controlling entity (sometimes referred to as a 'parent entity')) 'controls' the other entity (controlled entity). Assessing whether a reporting entity has a control relationship with another entity for financial reporting purposes can be complex and subjective. A thorough assessment of the facts and circumstances is required in each case.
15. Control for financial reporting purposes is defined in PBE IPSAS 6 (NFP) as "the power to govern the financial and operating policies of another entity so as to benefit from its activities". In addition to having the capacity to direct the use of the resources and benefits derived from the activities of another entity, the reporting entity may also be exposed to the financial risk³ of that other entity.
16. 'Control' when used in the context of financial reporting has a power element and a benefit element to it. As well as having the capacity to direct the use of the resources from the activities of another entity (power element), the controlling entity must also have the ability to benefit, either directly or indirectly (for example, the other entity provides services that meet the service objectives of the controlling entity), from the activities of another entity. The power element and benefit element may also be present where the controlling entity has the ability to wind up an entity and obtain a significant level of the residual economic benefits. The residual economic benefits could go directly to the controlling entity or the controlling entity could determine that those benefits go to another entity.
17. Where a reporting entity controls another entity for financial reporting purposes, the reporting entity prepares consolidated financial statements in accordance with PBE IPSAS 6 (NFP) *Consolidated and Separate Financial Statements* (Not-for-profit).

Joint Control Relationship

18. The key characteristic of a joint control relationship for financial reporting purposes is the agreed sharing of control over an activity by two or more parties and/or exposure to financial risk regarding that activity. This is achieved by way of a binding arrangement⁴, which is an arrangement between the parties that confers the rights and obligations on the parties to it as if the arrangement were in the form of a contract. PBE Standards refer to this type of relationship as 'joint control': the agreed sharing of control over an activity by a binding arrangement.

² Section 7 of the Companies Act 1993.

³ Financial risk is the risk that the reporting entity will lose its 'investment' in the other entity or be required to meet the financial obligations of the other entity in the event that the other entity is dissolved or wound-up.

⁴ See paragraphs 7–10 of PBE IPSAS 8 *Interest in Joint Ventures* for more discussion regarding binding arrangements.

19. Joint control requires the parties to agree the terms and conditions of the activity and the services to be delivered. Joint control is not the same as an arrangement where two or more entities receive funding from another party to jointly deliver services in accordance with the terms of a funding agreement with that other party. The delivery of such services in return for the funding is a contractual relationship between the party providing the funding and the entities providing the services. Under a contractual relationship of this nature, the party providing the funding determines the services to be delivered under the contract.
20. Where there is a joint control relationship, the reporting entity applies PBE IPSAS 8 *Interests in Joint Ventures* and accounts for its involvement in the joint activity depending on whether the joint control relates to (i) operations or activities, (ii) assets, or (iii) an incorporated entity that has legal form.
21. Joint control can be sub-classified, with different accounting treatments for each type of classification as follows:
 - (a) *Joint control involving operations or activities.* Two entities agreeing to undertake a particular activity jointly, each contributing their expertise or experience where relevant to the joint objective. For example, two NFP entities combine their operations, resources and expertise to build, market and find tenants for low-cost accommodation. Since the reporting entity is undertaking its agreed component of the activity using its own resources, the entity accounts in its own financial statements for the expenses and liabilities that it incurs in its own name and for its share of the benefits derived from the activity.
 - (b) *Joint control involving assets.* Two entities agreeing to share the use of particular assets. For example, two NFP entities jointly purchase a property from which they each conduct their separate activities and also rent out the remaining unoccupied space of the building. The reporting entity recognises in its own financial statements its share of the joint assets, any liabilities that it has incurred in its own name and its share of any liabilities incurred jointly with the third party, its share of the benefits derived from the use of the shared assets, its share of expenses incurred jointly with the third party and expenses incurred directly in respect of its interest in the shared assets.
 - (c) *Joint control involving incorporated entities that have legal form.* For example, two entities holding an equal share in a company which provides counselling services. One of the following approaches may be adopted:
 - (i) *The equity method.* The reporting entity's interest in the other entity is initially recorded at cost. It is subsequently adjusted by the reporting entity's share of that other entity's change in net assets/equity since joint control was established. The reporting entity's statement of comprehensive revenue and expense reflects its share of the other entity's surplus or deficit for the period.
 - (ii) *Proportionate consolidation.* The reporting entity consolidates its share of the assets, liabilities, revenue and expenses of the other entity.

Significant Influence Relationship

22. In a significant influence relationship for financial reporting purposes, the reporting entity has the capacity to participate in, but not control or jointly control, decisions about the use of the resources and benefits derived from the other entity. PBE Standards refer to this type of relationship as 'significant influence'. Significant influence for financial reporting purposes relates to the reporting entity's ability to influence the financial and operating policies of another entity.
23. For significant influence to exist for financial reporting purposes, a reporting entity needs to have a financial interest in another entity. This enables the reporting entity to participate in the financial and operating policies of the other entity and exposes the reporting entity to some financial risk. This is termed an "ownership interest". In order for this to happen, the other entity needs to have a formal equity structure (for example, share capital) and the reporting entity needs to own some of that equity (that is, the reporting entity has a financial interest of an ownership nature in the other entity. In instances where a reporting entity "invests" in another entity by, for example, providing funding to develop assets, this does not result in the reporting entity having significant influence because the other entity may be able to obtain funding from other sources.⁵

⁵ See paragraphs 3 and 4 of PBE IPSAS 7 *Investments in Associates* for further guidance.

24. Where there is a significant influence relationship, the reporting entity applies PBE IPSAS 7 *Investments in Associates* and would apply the equity method to account for that other entity (see paragraph 21(c)(i) above).

Other Relationships

25. In a relationship that is not a control relationship or a joint control relationship or a significant influence relationship, the reporting entity has little or no capacity to direct/influence the resources and benefits of the other entity and has little or no exposure to any financial risk.
26. However, the reporting entity may have a relationship with another entity that is not one of control, joint control or significant influence. Examples of such relationships include:
- (a) The reporting entity has an investment in another entity and the benefits received comprise a return on that investment. The reporting entity applies PBE IPSAS 28 *Financial Instruments: Presentation*, PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and PBE IPSAS 30 *Financial Instruments: Disclosures* or PBE-SFR-A (NFP) *Public Benefit Entity Simple Format Reporting (Not-for-profit)*.
 - (b) The reporting entity receives substantial donations or grants from another entity. The reporting entity considers whether to apply PBE IPSAS 9 *Revenue from Exchange Transactions* or PBE IPSAS 23 *Revenue from Non-Exchange Transactions* or PBE-SFR-A (NFP) *Public Benefit Entity Simple Format Reporting (Not-for-profit)*.

APPENDIX A

Illustrative Decision Tree for Determining the Appropriate Accounting by a Reporting Entity for its Relationship for Financial Reporting Purposes with Another Entity

This flowchart is considered for each entity with which the reporting entity has a relationship for financial reporting purposes.

