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 preparing general purpose financial reports in accordance with standards issued by the External Reporting Board (XRB) or its sub-Board, the New Zealand Accounting Standards Board. It provides guidance on 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.

This Explanatory Guide is an explanatory document and has no legal status.

It supersedes Explanatory Guide A9 *Financial Reporting by Not-for-profit Entities: Identifying Relationships for Financial Reporting Purposes* issued in October 2014.

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CONTENTS

Introduction

1. The objective of this Explanatory Guide is to help not-for-profit (NFP) entities that prepare, a general purpose financial report, in accordance with standards issued by the External Reporting Board (XRB) or its sub-Board, the New Zealand Accounting Standards Board 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 accordance with the relevant accounting standards.

2. This Explanatory Guide was developed to explain the types of relationships that exist between entities for financial reporting purposes. If an 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. An NFP entity may need to apply the concepts in the relevant PBE Standards for the purpose of determining its tier for financial reporting purposes (i.e. for calculating size thresholds), or in accounting for certain relationships.

3. The objective of financial reporting is to provide information about the entity that is useful to a wide range of users for accountability and decision-making purposes.

4. The financial report 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 a financial report, a reporting entity is required to:

   (a) Determine the activities and transactions that should be included;

   (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 the financial report.

6. Guidance for NFP entities on determining the activities and transactions that should be included in the reporting entity's financial report is found in EG A8 *Financial Reporting by Not-for-profit Entities: The Reporting Entity*.

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

7. 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

8. 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. 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.

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

10. 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:

    (a) Control relationship;

    (b) Joint control relationship;

    (c) Significant influence relationship; or

    (d) Other relationship.

11. The way in which a reporting entity accounts for the above relationships varies to reflect the substance of the particular relationship.[1]

Control Relationship

12. 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 company.[2] 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. PBE IPSAS 35 *Consolidated Financial Statements* outlines ways in which control for financial reporting purposes can occur.[3]

13. 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 the reporting entity that controls another entity as a controlling entity but the term 'parent entity' is also commonly used. 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.

14. PBE IPSAS 35 states that "an entity controls another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity."[4] In addition, PBE IPSAS 35 explains that the purpose and design of the other entity must also be considered in assessing control.

15. For the purpose of financial reporting, PBE IPSAS 35 explains that an entity 'controls' another entity when it has:

    (a) Power over the other entity;

    (b) Exposure, or rights, to variable benefits from its involvement with the other entity; and

    (c) The ability to use its power over the other entity to affect the nature or amount of those benefits through its involvement with the other entity.

16. The definition of control in PBE IPSAS 35 has a power element and a benefit element, and a requirement that power be linked with benefits.

17. PBE IPSAS 35 refers to control that arises for financial reporting purposes through actions such as:

    (a) The controlling entity establishing the controlled entity and retaining control;

    (b) The controlling entity being given control of the controlled entity by a third party; or

    (c) The controlled entity ceding control to the controlling entity, as may arise when a number of affiliated entities elect to establish a governing body. It is common in the not-for-profit sector to operate within a national and/or regional structure where the over-arching governing body sets the financial and operating policies under which the affiliated entities agree to operate in order to achieve the common objectives of the group comprising the governing body and its affiliates.

18. Where a Tier 1, Tier 2 or Tier 3 reporting entity controls another entity for financial reporting purposes, the reporting entity prepares consolidated financial statements in accordance with PBE IPSAS 35. A reporting

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[1] A summary of the Tier 1 and Tier 2 PBE Accounting Requirements for various types of relationships is set out in Flowchart 1 of PBE IPSAS 35 *Consolidated Financial Statements*.

[2] Section 7 of the Companies Act 1993.

[3] PBE IPSAS 35 is effective for annual periods beginning on or after 1 January 2019. Entities reporting for earlier periods should refer to PBE IPSAS 6 *Consolidated and Separate Financial Statements* (NFP).

[4] Paragraph 14 of PBE IPSAS 35.

entity that qualifies to, and elects to, report in accordance with the Tier 4 PBE Accounting Requirements, does not prepare consolidated financial statements, but it must still comply with any relevant requirements in that standard. However, the concept of control may still be relevant for some smaller NFP entities, as XRB A1 *Application of the Accounting Standards Framework* requires that a PBE determines its eligibility to report in accordance with Tier 4 PBE Accounting Requirements based on the total combined operating payments of the entity and any entities that it controls.

Joint Control Relationship

19. 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. Where there is a joint control relationship, the reporting entity applies PBE IPSAS 37 *Joint Arrangements*[5] to determine what type of joint arrangement it has and how to account for that arrangement. PBE IPSAS 37 identifies two types of joint arrangements: joint operations and joint ventures. A joint arrangement is an arrangement of which two or more parties have joint control. Joint control, as defined in PBE IPSAS 37, exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. The parties must control the arrangement collectively.

20. When there is joint control the parties will have jointly agreed 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.

21. In classifying a joint arrangement as a joint operation or a joint venture it is necessary to consider how it has been established as well as the nature of the entities' rights and obligations.

    (a) A joint operation is defined as "a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement."[6] Two entities could establish a joint operation by agreeing to undertake a particular activity jointly, each contributing certain resources and their expertise or experience, but without setting up a separate entity. If they set up a separate entity, the joint arrangement is more likely to meet the definition of a joint venture. Entities in a joint operation account for the assets, liabilities, revenue and expenses relating to their interest in the joint operation. For example, two NFP reporting entities might establish a joint operation by agreeing to combine their operations, resources and expertise to build, market and find tenants for low-cost accommodation. Each NFP entity would account in its own financial report for the expenses and liabilities that it incurs, the assets that it owns, the revenue that it earns in its own name and its share of the costs incurred and benefits derived from the activity.

    (b) A joint venture is defined "as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement."[7] In other words, a joint venture is a contractual arrangement that gives the entities rights to a share of the net outcome generated by an activity. Joint arrangements that are set up with separate legal form would generally meet the definition of a joint venture in PBE IPSAS 37. For example, two NFP reporting entities might hold an equal share in a company which provides counselling services. If their rights and obligations are based on their shares in the company, this would be classified as a joint venture under PBE IPSAS 37. A joint venture is accounted for using the equity method in accordance with PBE IPSAS 36 *Investments in Associates and Joint Ventures*.[8] Under this 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.

[5] PBE IPSAS 37 is effective for annual periods beginning on or after 1 January 2019. Entities reporting for earlier periods should refer to PBE IPSAS 8 *Interests in Joint Ventures*.

[6] Paragraph 7 of PBE IPSAS 37.

[7] Paragraph 7 of PBE IPSAS 37.

[8] PBE IPSAS 36 is effective for annual periods beginning on or after 1 January 2019. Entities reporting for earlier periods should refer to PBE IPSAS 7 *Investments in Associates*.

22. Where a Tier 1, Tier 2 or Tier 3 reporting entity is a party to a joint arrangement, as defined in PBE IPSAS 37, it accounts for that arrangement in accordance with the relevant requirements in PBE Standards. A reporting entity that qualifies to, and elects to, report in accordance with the Tier 4 PBE Accounting Requirements, complies with any relevant requirements in that standard.

Significant Influence Relationship

23. 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.

24. PBE IPSAS 36 defines significant influence and establishes the requirements for accounting for an associate (being the entity over which the investor has significant influence) and joint ventures. The scope of PBE IPSAS 36 is limited to investments that lead to the holding of a quantifiable ownership interest. An ownership interest arises when a reporting entity has a financial interest in another entity which 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. Quantifiable ownership interests include a share of a formal equity structure (for example, share capital) or a share in a partnership. 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.[9]

25. Where a Tier 1, Tier 2 or Tier 3 reporting entity has a significant influence relationship that falls within the scope of PBE IPSAS 36, the reporting entity uses the equity method to account for its interest in that other entity (see paragraph 22(b) above). A reporting entity that qualifies to, and elects to, report in accordance with the Tier 4 PBE Accounting Requirements, complies with any relevant requirements in that standard.

26. An entity could have a non-quantifiable ownership interest. PBE IPSAS 38 *Disclosures of Interests in Other Entities* requires disclosure of the type of interests in other entities to assist users in understanding the nature of these relationships.

Other Relationships

27. Whether the affiliation of a number of entities leads to a group consisting of a controlling entity and its controlled entities requires judgement. In some cases, entities affiliate to share resources or as a means of achieving their individual aims. For example, sporting entities might affiliate to create a sporting competition, and operate independently in all respects other than that the entities have agreed to conform to the playing rules for the purposes of the competition. In these circumstances, control is unlikely to exist because the sporting entities have agreed to conform to the playing rules for the purposes of the competition: in all other aspects, they operate independently of each other. In other cases, entities agree to work together to achieve a common aim while operating in local groups as that better achieves their objectives. For example, a youth organisation might conduct its activities through local groups in order to better provide services, with each local group conforming to the policies that have been set by the central governing body. Whether the governing body is elected by the local groups or appointed through some other mechanism does not impact on the existence or non-existence of control by the governing body over the local groups. In these circumstances it is likely that the youth organisation controls the local groups because the central governing body of the youth organisation has set the policies that the local groups conform to, and the youth organisation conducts its activities through the local groups to better provide services.

28. In the case of trusts, careful consideration is required to determine whether the relationship between a reporting entity and a trust is such that the entity controls the trust for financial reporting purposes. If the reporting entity's only relationship with the trust is as a trustee of the trust, and not also as a beneficiary, the reporting entity is unlikely to have control over the trust because its relationship with the trust is likely to represent a fiduciary relationship rather than a control relationship. However, in other cases, the reporting entity may need to assess its relationship with a trust to see if it controls the trust for financial reporting purposes.

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[9] See paragraphs 4 and 5 of PBE IPSAS 36 *Investments in Associates and Joint Ventures* for further guidance.

29. 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.

30. 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 the following.

    (a) The reporting entity has an investment in another entity and receives a financial return on that investment. In such cases the reporting entity applies the relevant PBE Accounting Requirements. For example, an entity reporting in accordance with the Tier 2 PBE Accounting Requirements would refer to PBE IPSAS 28 *Financial Instruments: Presentation*, PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* (or PBE IFRS 9 *Financial Instruments*), and PBE IPSAS 30 *Financial Instruments: Disclosures*.

    (b) The reporting entity receives substantial donations or grants from another entity. In such cases the reporting entity applies the relevant PBE Accounting Requirements. For example, an entity reporting in accordance with the Tier 2 PBE Accounting Requirements would consider whether to apply PBE IPSAS 9 *Revenue from Exchange Transactions* or PBE IPSAS 23 *Revenue from Non-Exchange Transactions*.

    (c) The reporting entity may have entered into a network and partner agreement with another entity or entities. The equivalent term used by for-profit entities is franchise agreements. Although such agreements establish rights and obligations and give rise to benefits, they may not give rise to control for financial reporting purposes. PBE IPSAS 35 has guidance on identifying network and partner agreements.