Chapter 2 – Reporting Entity

Key points

- A reporting entity is an entity which provides financial statements to external users as the major source of financial information about the entity.
- The reporting entity concept determines which activities or operations are covered by the financial statements. The reporting entity for which financial statements are prepared may be broader or narrower than what is commonly thought of as the not-for-profit entity.
- Where an entity is a separate legal entity the relevant legislation often specifies the reporting entity.
- A not-for-profit entity which does not have any branches, or conducts its activities through other groups or organisations or affiliated bodies, prepares financial statements for its own assets and liabilities, income and expenses.
- Where a not-for-profit entity has branches, or conducts its activities through other groups or organisations or affiliated bodies which form part of the same legal entity as the not-for-profit entity the transactions of these branches etc will form part of the not-for-profit entity's financial statements. Where these activities occur in separate entities, the not-for-profit entity may need to include some or all of the assets and liabilities, income and expenses of those other entities in consolidated financial statements (which are a set of combined financial statements).
- Where a not-for-profit entity has branches, or conducts its activities through other groups or organisations or affiliated bodies these other entities may be reporting entities in their own right.
- If it is not clear which activities should be included within an entity's financial statements, specialist advice may be needed.

Introduction

2.1 A reporting entity is "an entity which prepares general purpose financial statements for users who rely on those financial statements as their major source of financial information about the entity" (NZ *Framework*). In other words it is the entity that is the subject of financial statements in an annual report.

2.2 In some cases it is easy to identify the reporting entity. A separate legal entity that is required (for example, by its constitution, trust deed or legislation) to prepare financial statements is usually also the reporting entity. This will be the case for the majority of not-for-profit entities.

2.3 However, identifying the reporting entity is not so clear cut if the entity:

- is not specifically required to prepare financial statements; and
- is part of a group or operates in conjunction with other linked organisations.

2.4 If an entity has no clear requirement to prepare financial statements it needs to consider whether there are external users which rely upon its financial statements to find out information about the entity. For example, a national group which is a separate legal entity may have five regional branches which are not themselves separate legal entities and which are not required by legislation or their constitution to prepare financial statements. However, the branches may consider that they have a responsibility to provide a public report due to their role in the community. Individual branches can present their own financial statements, and should do so in accordance with generally accepted accounting practice (GAAP). In this situation each branch is a reporting entity.

2.5 This chapter explains how to identify the reporting entity for some common structures used by not-for-profit entities:

- a not-for-profit entity with branches which carry out specific activities of the entity, or operate in a particular geographical area (these branches may or may not be separate legal entities)
- a not-for-profit entity with one or more sub-entities such as trusts or trading companies
- a not-for-profit entity that is the national body of a federation of local organisations and co-ordinates the activities of those organisations
- a not-for-profit entity which carries out activities in partnership with other bodies but without establishing a separate legal entity. For example, a church may enter into a joint arrangement with other churches to carry out certain activities.

2.6 Mergers of entities and the acquisition of one entity by another can also occur but are not covered in this Guide. Guidance on accounting for mergers and acquisitions can be found in NZ IFRS 3 *Business Combinations.*

"Control" and "significant influence"

2.7 Working out how to account for different parts of a not-for-profit entity often depends on whether the overall (parent) not-for-profit entity controls or has significant influence over the other parts (such as branches and sub-entities).

Control

2.8 Control is the power to govern the financial and operating policies of an entity so as to receive benefits from its activities (NZ IAS 27 *Consolidated and Separate Financial Statements* paragraph 4). Control often exists when one entity has created or acquired another entity.

2.9 NZ IAS 27 provides guidance on determining whether control exists (NZ IAS 27 paragraphs 13 to 21). Power to govern the financial and operating policies of an entity so as to receive benefits from its activities exists when the parent entity:

- owns more than half of the voting power of an entity;
- has power over more than half of the voting rights;
- has the power to govern the financial and operating policies of the entity under a statute or agreement;
- has the power to appoint or remove the majority of the members of the board of directors or equivalent governing body that runs the entity; or
- has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body that runs the entity.

2.10 This means that a not-for-profit that has branches and, in accordance with NZ IAS 27, is able to govern the financial and operating policies of the branches has control over those branches.

2.11 There is more information on control in FRS-37 *Consolidating Investments in Subsidiaries* (paragraphs 4.13–4.37 and 5.9–5.11) and International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (paragraphs 26–36)[12]. This additional guidance applies only to public benefit entities (NZ IAS 27 paragraph NZ 12.1).

Significant influence

2.12 Significant influence is the power to participate in financial and operating policy decisions but not control them (NZ IAS 28 *Investments in Associates* paragraph 2). A holding of 20% or more of the voting power (directly or through subsidiaries) indicates significant influence unless it can be clearly demonstrated otherwise. If the holding is less than 20%, the entity is presumed not to have significant influence unless influence can be clearly demonstrated by other means (NZ IAS 28 paragraph 6).

2.13 Significant influence is usually shown in one or more of the following ways:

- representation on the board of directors or equivalent governing body;
- participation in the policy-making process;
- material transactions between the two entities;
- interchange of managerial personnel; or
- provision of essential technical information (NZ IAS 28 paragraph 7).

2.14 This means, for example, if a charity beneficially holds 20% or more of the voting rights in another entity, it would be presumed to have the power to participate in and influence over the other entity's operating and financial policy, unless this was proven not to be the case. The charity would have significant influence over the other entity.

Branches

2.15 Many not-for-profit entities have branches, which will be either part of the overall legal entity or separate legal entities in their own right.

2.16 If the branches are part of the overall legal entity, they are included in the overall entity's financial reports. This means that the transactions and balances of the branches (for example, their assets and liabilities) are included in the financial statements of the overall not-for-profit entity. Even where branches form part of the overall legal entity they may be reporting entities in their own right and may have an obligation (explicit or inferred) to provide financial statements to their members on the activities of the branch.

[12]Although IPSAS 6 is the more recent pronouncement, the guidance in FRS-37 is more relevant for not-for-profit entities because it was developed for application by a wide range of entities. IPSAS 6 which was developed for application by public sector entities drew heavily on the material in FRS-37. Exposure Draft 112 Proposed Application Guidance for NZ 1AS 27 *Consolidated and Separate Financial Statements* to Assist in Determining Whether a Public Benefit Entity Controls Another Entity (June 2007) is also relevant.

2.17 If the branches are separate legal entities the overall not-for-profit entity may control the branches or have significant influence over them. If the overall entity has control, the branches are accounted for as subsidiaries; and if the overall entity has significant influence, the branches are accounted for as associates in the financial statements of the overall entity (see below). The constitution or other documents such as trust deeds may help to determine whether a branch is controlled or under significant influence. Some branches may have sub-branches. In such cases it is necessary to consider whether the sub-branches form part of the branch and whether the sub-branches are reporting entities in their own right.

2.18 If a not-for-profit entity has branches the notes to the financial statements should clearly state whether the financial activities of the branches are included in the overall entity's financial statements and whether the branches produce their own financial statements.

2.19 Branches need to consider whether they should prepare general purpose financial statements. If the only user of a branch's financial statements is the overall not-for-profit entity it is unlikely that general purpose financial statements are necessary.

2.20 Groups of people who occasionally gather together to raise funds for a charity, and special interest groups that are affiliated to a particular charity but do not themselves undertake charitable activities, are not branches and their financial activities should not usually be combined with those of the reporting entity.

Sub-entities such as trusts or trading companies

2.21 A not-for-profit entity that has established separate legal entities, such as trusts or trading companies, to carry out specific functions will need to consolidate the financial statements of those entities unless the founding entity does not control those separate entities. The methods of accounting for sub-entities that are controlled (subsidiaries) and those that are subject to significant influence (associates) are discussed below.

Federations

2.22 If a not-for-profit entity is the national body of a federation of local organisations and co-ordinates the activities of those organisations, it will need to determine whether it controls or has significant influence over the local organisations. Control is less likely to exist in a federation structure than in a branch structure. In many cases the national body merely supports, rather than controls, the local organisations. If the not-for-profit entity controls the local organisations it accounts for them as subsidiaries, and if it has significant influence it accounts for them as associates (see below).

Joint arrangements

2.23 Not-for-profit entities may undertake joint arrangements where they operate in partnership with other bodies but without establishing a separate legal entity. Such arrangements may meet the definition of joint ventures (see below) and need to be accounted for as such.

Accounting for controlled entities (subsidiaries)

2.24 If a not-for-profit entity controls another entity (that is, it governs the financial and operating policies of an entity so as to receive benefits from its activities), the not-for-profit entity (the parent) must prepare financial statements that include some or all of the assets and liabilities, income and expenses of the other entity in consolidated financial statements (which are a set of combined financial statements). The controlled entities are referred to as the subsidiaries of the parent entity. A number of adjustments such as the elimination of transactions between the entity and subsidiaries are required when preparing consolidated financial statements.

2.25 In some instances a not-for-profit entity with subsidiaries will be required to present both consolidated financial statements and financial statements for the parent entity alone. This requirement would be specified in an entity's founding documents or legislation. Parent entity statements are not required by financial reporting standards. If both sets of statements are required they are usually presented as two columns in a single report.

2.26 There are some exceptions to the requirement to consolidate subsidiaries. For example, if the not-for-profit entity is itself a wholly owned subsidiary, it may not be required to produce consolidated financial statements (NZ IAS 27 paragraph 10).

2.27 Some situations will require careful consideration. For example, a not-for-profit entity may establish another entity for the purpose of providing independent advice on its activities. Such complex situations are not covered by this document. In such cases you will need to consider the detailed requirements of the relevant reporting standards and seek specialist advice.

2.28 When an entity has a subsidiary in which it controls less than half of the voting power, it has to disclose the nature of the relationship between itself and the subsidiary in the notes (NZ IAS 27 paragraph 40(c)).

Accounting for significant influence (associates)

2.29 NZ IAS 28 explains how an entity accounts for another entity over which it has significant influence (and that other entity is not a subsidiary or an interest in a joint venture). Such entities are referred to as associates. Associates are relatively uncommon in the not-for-profit sector but can occur.

2.30 The requirements in NZ IAS 28 set out a method of accounting referred to as the equity method. Under this method a not-for-profit entity with an associate recognises its share of the associate's surplus or deficit (less any unrealised profits on transactions between the entity and the associate).

Accounting for jointly controlled activities (joint ventures)

2.31 In a joint venture situation, an activity is jointly controlled by two or more parties. For example, a number of churches may jointly establish a separate entity to advocate on issues which are of interest to all the churches and to provide aged care services. NZ IAS 31 *Interests in Joint Ventures* deals with how to identify a joint venture and how to report the activities of a joint venture in the financial statements of the parties that have joint control.

2.32 NZ IAS 31 states that joint control exists when the strategic financial and operating decisions for the activity require the unanimous consent of the parties (NZ IAS 31 paragraph 3). It is possible for a not-for-profit entity to beneficially hold 20% or more of the voting rights in an undertaking but for the management arrangements to be such that control is clearly shared with the other partners. In this case the undertaking is a joint venture rather than an associate.

2.33 The method of combining information on the joint venture's financial activities in the consolidated financial statements depends on the type of joint venture. An entity with an interest in a joint venture can recognise its interest in a joint venture in the financial statements by either proportionate consolidation or the equity method. NZ IAS 31 explains these methods.

Maintaining records

2.34 If a not-for-profit entity has subsidiaries, associates or joint ventures it will need to maintain records of transactions between itself and each of these other entities during each period so that the requirements of relevant financial reporting standards can be complied with. When an entity prepares consolidated financial statements NZ IAS 27 requires that it eliminate intragroup balances (for example, loans between the not-for-profit entity and its subsidiary) income and expenses.

Registered charities

2.35 Provision exists within the Charities Act 2005 for a group of charities to be treated as if they were a single entity. The requirements for group registration are met if the Commission is satisfied that:

- each of the organisations within the group qualifies for registration as a charitable entity; and
- all of the organisations are sufficiently closely related; and
- it is fit and proper to treat the organisations as forming part of a group.

In addition, the Commission must have regard to the extent to which the entities have similar charitable purposes.

2.36 Charities registered as a group under the Charities Act will be subject to any requirements of the Charities Commission in respect of such groups. However, it is not a requirement for group registration that the entities registering be part of an accounting group and, accordingly, such groups of charities will not necessarily be the same as the reporting entity under NZ IFRSs.

Examples – identifying the reporting entity

2.37 The following examples identify the reporting entity in various situations.

Please note

The examples here are simplified and do not address the specific circumstances of any particular entity. Each entity will need to consider the facts in its own situation and the application of NZ IAS 27, NZ IAS 28 and NZ IAS 31 to those facts.

These examples do not deal with acquisitions or disposals of entities.

Example 1

A sports club is required by its constitution to prepare general purpose financial statements. The club receives some funding from a national body but is independent of that body. The club has not formally established any other clubs or groups.

The reporting entity is the sports club. The financial statements would include the assets and liabilities, and revenue and expenses of the sports club.

Example 2

An incorporated society is a national body with three branches – Auckland, Wellington and Christchurch. The national body receives funding from the Government and co-ordinates fundraising activities by all branches. The national body decides which services will be provided to clients and approves the budgets of each region. The branches are not separate legal entities.

The reporting entity is the national body, including the three branches. The financial statements are not consolidated financial statements because legally the branches are part of the national body. As noted in paragraph 2.4 of this Chapter, the branches may also have an obligation to produce general purpose financial statements and be reporting entities in their own right.

Example 3

An incorporated society is a national body with ten branches throughout New Zealand. The branches are separate incorporated societies. The governing bodies of the branches are appointed by local members and the branches are free to establish their own rules. Each area conducts its own fundraising activities and decides how to spend money raised in its region. The branches pay a fee to the national body, which provides advocacy and other support services. The national body does not fund the activities of the branches. In the event of dissolution, the constitution of each local branch states that any residual assets are to be distributed to entities with related not-for-profit objectives.

The national body and the branches are all separate reporting entities. As the national body has no control over the branches it would not consolidate them in its financial statements.

Example 4

A not-for-profit entity (A) that provides services to low-income families establishes another entity (B) to manage the houses that it owns and which are available for rent by its clients. The board of entity B is appointed by the board of entity A. Entity B operates as a property management agency deciding which applicants can rent houses and the amount of the rental, and has considerable autonomy in doing this. If entity B makes a profit it distributes some of that profit to entity A. If entity B makes a loss it can seek additional funding from entity A. The documents that establish entity B require it to prepare separate financial statements.

Entity B is controlled by entity A. Entity A would prepare consolidated financial statements that include entity B's transactions and balances.

Entity B would also prepare separate financial statements because it is required to do so by its founding documents. If this specific requirement did not exist, entity B would need to consider whether there were any external users who relied upon financial statements to find out information about entity B.

Example 5

A charitable trust provides food and accommodation to homeless people. It regularly liaises with other community groups and works with those groups to ensure its services are provided in the areas where they are most needed. It has a group of supporters that help raise money for its activities.

The reporting entity is the charitable trust. It does not control (or jointly control) the activities of the other groups. Nor does it control the supporters.

Example 6

National Body A is an umbrella body with a number of affiliated associations which operate in various regions around the country. National Body A imposes certain rules and standards on the associations. It does not have the power to wind up its affiliated *associations, but it is able to prevent them from using the name of the National Body. National Body A levies its associations at a fixed fee per member.*

The governing bodies of the affiliated associations are appointed by the members of those associations. The governing bodies have financial and operating policy-making powers, subject to the rules and standards of the National Body.

The reporting entity is National Body A. It does not control the affiliated associations.

Each affiliated association may also be a reporting entity. For example, they would be reporting entities if they have obligations to prepare financial statements or if there are external users who rely upon financial statements to find out information about them.