
REPORTING ENTITY CONCEPTS FOR TIER 1 AND TIER 2 NFP ENTITIES

WORKING GROUP REPORT

NOVEMBER 2012

This document is a report of a working group established by the NZASB to consider reporting entity concepts for financial reporting for Tier 1 and Tier 2 not-for-profit entities. The report is designed to be an input into the work of the NZASB for consideration by the NZASB in developing PBE Standards.

The views expressed in this document are those of the Working Group alone. They do not necessarily represent the views of the NZASB. The extent to which, and manner in which, these views (if any) are incorporated into PBE Standards remains to be determined and will be considered by the NZASB as it develops accounting standards for Tier 1 and Tier 2 not-for-profit entities.

This document does not represent an official pronouncement of the NZASB.

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PART A: INTRODUCTION

1. The New Zealand Accounting Standards Board (NZASB) established the Not-for-Profit (NFP) Working Group to provide advice on key items of guidance to be included in the draft PBE Standards for Tier 1 and Tier 2 not-for-profit entities. The members of the Working Group were:

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2. The Working Group was asked to provide advice to the NZASB about the nature of the Not-for-Profit sector in respect of Tier 1 and Tier 2 entities (as determined by the XRB Accounting Standards Framework). In this context, the Working Group considered the application of notions of reporting entity. Issues within this topic include:
 - (a) structures within Registered Charities,
 - (b) current practices to combine and/or consolidate entities,
 - (c) combinations, and
 - (d) consolidations.
3. This Report represents the Working Group's views and is provided for consideration by the NZASB.

PART B: THE PROCESS

4. The Working Group identified a three-step process for an entity on the register of charitable entities (registered charity) to follow in considering these issues. The Working Group specifically considered registered charities because of the proposal in the Financial Reporting Bill 2012 to require registered charities to follow standards issued by the XRB. This means the step to identify users is already taken for the charity. (If not-for-profit entities are voluntarily applying financial reporting standards, they should identify the service recipients and resource providers that could be users of their GPFR).
5. The proposed steps are:
 - (a) identify the entity for which a GPFR is required to be prepared;
 - (b) identify other entities with which the reporting entity has a relationship for financial reporting purposes; and
 - (c) where a relationship for financial reporting purposes exists, identify the appropriate recognition of such a relationship in the reporting entity's GPFR.
6. Each of these steps is addressed in the following sections.

PART C: STEPS TO IDENTIFY THE REPORTING ENTITY AND TO CONSIDER ISSUES

STEP 1: IDENTIFY THE ENTITY FOR WHICH A GPFR IS REQUIRED TO BE PREPARED

7. The reporting entity is the entity that is required by law to prepare financial statements in accordance with standards issued by the XRB/NZASB. These financial statements are described as general purpose financial reports (GPFR). For example, if an entity is registered as a charity the Financial Reporting Bill 2012 proposes that it is required to file a GPFR with the charities register. This entity (the registered charity) may be incorporated or unincorporated; it could be a subset of a legal entity; or it could consist of a combination of legal (incorporated) and/or unincorporated entities.
8. Included within the reporting entity's GPFRs should be all of the activities of that entity based on the definitions of assets, liabilities, equity, revenue and expenses in the applicable conceptual framework. For example, if a registered charity is unincorporated, in preparing a report for that entity it would be necessary to identify and collate all of the transactions and balances of that entity (rather than the financial affairs of individuals who act on behalf of the entity).
9. The composition of the reporting entity often is determined by the legal status of the entity as the statutory requirement to prepare financial statements is derived from the entity's legal status. The reporting entity may be relatively simple to identify if it is a company or an incorporated association. It may be more complex in other cases. For example, a charitable organisation consisting of many branches may register as a single charity. This single registration requires the GPFR prepared for that charity to comply with its registration and include all the activities of the entire organisation, including all its branches. Conversely, an entity may register each of its branches separately, thus is required to prepare a separate GPFR to be filed for each branch, even though each branch is not a separate legal entity. (However, a 'Head Office' that is registered needs to consider its relationship with its branches in order to prepare and file GPFR as noted in paragraph 12).
10. The registered entity's components may be changed, in which case the scope of the reporting entity may change. For example, charities can choose to change their registration from registration as a single organisation (requiring a single GPFR) to registration as multiple entities (requiring a separate GPFR for each registered entity).
11. If the composition of the reporting entity is unclear, such as when the entity is unincorporated, the following will assist in determining which activities, transactions and balances are within the boundaries of the reporting entity.
 - (a) All activities undertaken using the reporting entity's registered identity, (for example charity registration) are considered to be activities of the reporting entity.
 - (b) Transactions undertaken and balances held in the name of the reporting entity (such as transactions and balances in the entity's bank account) and transactions held out to be undertaken on behalf of the reporting entity are considered to be transactions and balances of the reporting entity.

- (c) Funds and associated transactions are considered to be funds and associated transactions of the reporting entity if they are solicited in the name of, and with the express or implied approval of, the reporting entity. This also includes the case where substantially all of the funds solicited are intended by the contributor, or are otherwise required, to be transferred to the reporting entity or used at its direction (even if at a local level only).
 - (d) Transactions and balances that are recognised by the entity as per the definitions of assets, liabilities, equity, revenue and expenses in the applicable conceptual framework.
12. Many organisations operate through branches or similar units. Where the branch is a component of the reporting entity, the activities of the branch are incorporated into the GPFR of the reporting entity. This does not prevent the preparation of such reports about the activities of a branch to meet the needs of the members of that branch for financial information. Such reports may be prepared using standards issued by the XRB/NZASB on a voluntary basis or it may be prepared solely to meet the information needs of members of that branch in a form that is appropriate in the circumstances.
13. An organisation may have organisational members. The existence of members does not necessarily mean that those members are part of the reporting entity. For example, members of an umbrella organisation are unlikely to be part of the umbrella organisation reporting entity because:
- (a) members can choose whether or not to be a member of the reporting entity;
 - (b) the reporting entity does not necessarily have access to a member's resources or control over the member's activities; and
 - (c) members typically are not responsible for the obligations of the reporting entity.

STEP 2: IDENTIFY OTHER ENTITIES WITH WHICH THE REPORTING ENTITY HAS A RELATIONSHIP FOR FINANCIAL REPORTING PURPOSES

14. The Working Group considered a number of factors that would assist in identifying whether the reporting entity has a relationship with another entity for financial reporting purposes. This Report uses the term “relationship” to describe where a relationship for financial reporting purposes exists. Step 3 considers how, if at all, that relationship should be reflected in the entity’s GPFR.
15. The Working Group concluded that three elements must exist for a reporting entity to have a relationship for financial reporting purposes with another entity. These elements are:
- (a) a relationship for financial reporting purposes between the reporting entity and the other entity must exist (**‘relationship’** element); and
 - (b) the reporting entity is:
 - (i) exposed to residual financial risk of the other entity (**‘risk exposure’** element); and/or
 - (ii) has the capacity to direct/influence the use of the resources and benefits derived from the activities of the other entity (**‘benefit’** element).
16. Relationships between entities arise in a variety of ways and the underlying circumstances vary. Determining whether the above elements exist and applying the factors discussed below often requires the application of judgement in the context of the particular circumstances of each entity. Further, these elements must be considered from a “substance over form” perspective rather than a legal perspective.
17. Legal form may determine and/or affect relationships between entities. However, relationships can be created under any arrangement or mechanism and are not restricted to relationships that arise through legal structures such as ownership instruments. Therefore, in assessing relationships between entities and the existence of the key factors above it is essential to consider the substance of the relationship between the entities.

Relationships that may not create a relationship for financial reporting purposes

18. Various forms of relationship exist that provide for one entity within the relationship to direct some of the activities of another entity in the relationship. The following types of relationships do not, of themselves, lead to a relationship for financial reporting purposes.
- (a) *Regulatory relationship*: A regulatory relationship exists when there is a specific authority under regulation to impose a specified form of compliance on the regulated entities.

- (b) *Purchase relationship*: A purchaser of goods or services (including membership or access to facilities) may be able to compel the supplier to follow a certain course of action.
- (c) *Donative relationship*: The donor may have the capacity to impose specific conditions on an entity as a result of making donations to the entity.
- (d) *Lending relationship*: A lender, through a lending arrangement, may be able to compel the borrower into a certain course of action.
- (e) *Membership relationship*: A membership organisation generally requires members to undertake certain activities or to follow rules as a consequence of joining it.

19. Further, fiduciary relationships do not necessarily lead to a relationship for financial reporting purposes. Fiduciary relationships, such as those between trustees and beneficiaries of trusts, might appear to be such relationships. However, they do not necessarily lead to a relationship as defined in this paper because they can be distinguished from such an interest in a number of ways.

- (a) The decision-making power of a trustee does not meet the ‘capacity to direct/influence the use of the benefits’ element of a relationship for financial reporting purposes because this capacity is governed by the trustee’s fiduciary responsibility at law to act in the best interests of the beneficiaries of the trust.
- (b) A trustee’s entitlement to benefits does not meet the ‘benefit’ element of a relationship because any link between the decision-making powers of a trustee and the trustee’s entitlement to benefits is different in nature to the link between the ‘capacity to direct the use of benefit’ and ‘benefit’ elements that exist in a relationship.
- (c) A settlor of a trust does not have a relationship with the trust for financial reporting purposes unless the settlor has retained the right to direct/influence the trust by way of an auto-pilot mechanism (refer paragraphs 26-28).
- (d) A beneficiary of a trust does not have a relationship with the trust for financial reporting purposes unless they can direct/influence the trust by way of an auto-pilot mechanism (refer paragraphs 26-28).

Identifying exposure to residual risk (‘risk exposure’ element)

20. Residual risk refers to financial risk. Financial risk does not include, for example, reputational risk. However, it includes both legal and in-substance exposure. It therefore includes constructive obligations such as instances where the reporting entity through an announcement or through its past practice has created a valid expectation that it will support the other entity and so will be compelled to do so.

21. The reporting entity is exposed to residual financial risk in another entity when, in substance, the reporting entity retains some of the residual financial risks. The following indicators may suggest that the reporting entity may be exposed to risk in respect of another entity.
- (a) The reporting entity is exposed to risk of a potential financial loss in relation to the other entity (including potential loss of any of its interests in the other entity).
 - (b) The reporting entity can dissolve the other entity and then bear the residual obligations.
 - (c) The reporting entity is exposed to the liabilities of the other entity.
 - (d) The reporting entity guarantees *significant* liabilities of the other entity. The extent to which the reporting entity guarantees the liabilities of another entity determines whether the reporting entity is exposed to the residual financial risks of the other entity.
22. Economic dependence of an entity on another entity does not, by itself, lead to one entity having a relationship with the other.

Identifying the capacity to direct/influence the use of the resources and benefits derived from the activities of the other entity ('benefit' element)

23. The 'benefit' element is satisfied when the reporting entity, in substance, has the capacity to direct or influence the use of benefits derived from the activities of another entity. The critical factor in assessing whether this is the case is whether the reporting entity has the ability, capacity or right to direct or influence the other entity to act in a particular manner to support the objectives of the reporting entity in some way. Satisfying the 'benefit' element is not dependent on whether the reporting entity is the actual recipient of the benefits.
24. There must be an ability to impact decisions about the use of benefits but to have such an ability does not require it to be probable that benefits will arise. The critical factor is that, in the event that such benefits do arise, the reporting entity has the ability to direct the use of those benefits in accordance with its objectives. The substance of the entity's capacity, rather than the legal form, needs to be considered in assessing the benefit element: the capacity will exist only where the reporting entity has a realistic ability to direct/influence the use of any benefits.
25. In some cases the reporting entity may, through legal or other means, have decision-making rights. Different forms of rights that exist and rights that, if they exist, indicate that the 'benefit' element is satisfied, are listed in Appendix One. The Working Group realised that identifying the benefit element is not always straight-forward and suggest that the items included in Appendix One could form part of Application Guidance for the NFP sector.

Trusts and other “auto-pilot” mechanisms

26. NFPs may create other entities to achieve some of their objectives. Such other entities may take the form of a corporation, trust, partnership or unincorporated entity. Often these entities are created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operations of the entity. Frequently, these provisions specify that the policy guiding the on-going activities of the entity cannot be modified, other than by its creator or sponsor. These created entities are often described as being on “autopilot” or being “structured entities”.
27. However, economic dependence of an entity on the reporting entity does not, by itself, lead to the reporting entity having a relationship with that entity. In addition, if an entity’s activities are predetermined until or unless particular circumstances arise, those circumstances need not have occurred for the reporting entity to have a relationship with the other entity.
28. The risk and benefit criteria identified in Step Two should be sufficient to capture entities described as being on “autopilot” or being “structured entities”. However, the Working Group recommends that the manner in which risks and benefits are defined in application guidance for the NFP sector should be drafted so as to ensure that these types of entities are captured when identifying the reporting entity. Factors that could be considered when identifying trusts and other “auto-pilot” mechanisms are listed in Appendix Two and could form part of Application Guidance for the NFP sector.

STEP 3: WHERE A RELATIONSHIP FOR FINANCIAL REPORTING PURPOSES EXISTS, IDENTIFY THE APPROPRIATE ACCOUNTING TREATMENT OF THAT RELATIONSHIP IN THE REPORTING ENTITY'S GPFR

29. This section considers the accounting applied by the reporting entity to the relationships for financial reporting purposes that the reporting entity has identified under Step 2.
30. Once a reporting entity has determined that it has a relationship with another entity it is necessary to consider whether the relationship is strong enough to justify consolidation of the related entity with the reporting entity or whether other forms of accounting should be applied.
31. Because relationships between entities arise in a variety of ways and the underlying circumstances vary; determining the extent of a relationship requires the application of judgement in the context of the particular circumstances of each entity.
32. Legal form may determine and/or affect relationships between entities. However, relationships can be created under any arrangement or mechanism and are not restricted to relationships that arise through legal ownership. Therefore, in assessing the extent of relationships between entities it is essential to consider the substance of the relationship.
33. The extent of a reporting entity's relationship is likely to vary. This can range from:
- a. bearing the majority of the risk and/or being able to direct/influence the use of the majority of the benefit from the activities of another entity; to
 - b. bearing little or no risk and/or having little or no ability to benefit from the activities of another entity.
34. A reporting entity's relationship with another entity is likely to fall into one of the following four categories, the accounting for which varies to reflect the substance of the relationship.
- (a) *Significant Relationship*: The reporting entity is exposed to the majority of the risks, and/ or has the capacity to direct the use of the majority of the benefits from the activities, of another entity. The reporting entity would consolidate the other entity for financial reporting as per the requirements of proposed PBE IPSAS 6 *Consolidated and Separate Financial Statements*.
 - (b) *Joint Relationship*: The reporting entity shares equally with at least one other entity the risks and/or the ability to direct the use of benefits from another entity. The reporting entity should equity account or proportionally consolidate as per the requirements of proposed PBE IPSAS 8 *Interests in Joint Ventures* (for financial reporting) the other entity.
 - (c) *Associate Relationship*: The reporting entity has some exposure to financial risk of, and/or the ability to significantly influence the direction of the use of benefits derived from the activities of, another entity. The reporting entity should account for its interest in the other entity using the equity method as per proposed PBE IPSAS 7 *Investments in Associates*.

- (d) *Insignificant Relationship*: The reporting entity has little or no exposure to the risks of, and/or little or no ability to direct the use of the benefits derived from, the activities of another entity. The reporting entity should account for its interest in the other entity at fair value if recognised as an asset or possibly as a donation if recognised as revenue.

Significant Relationship

35. A reporting entity should consolidate another entity when the substance of the relationship between the entities indicates that the reporting entity has a significant relationship with the other entity. A significant relationship cannot be shared. That is, only one reporting entity can have a significant relationship with a specific entity.
36. Consolidated financial statements are financial statements of an economic entity (reporting entity and those entities in which it has a significant relationship) presented as those of a single entity (the group reporting entity).
37. The purpose of consolidated financial statements is to present a true and fair view of the financial affairs of the reporting entity including all entities with which it has a significant relationship so that the assets and liabilities of the reporting entity are transparent.

Joint Relationship

38. The key characteristic of a joint relationship is a binding arrangement whereby two or more parties are committed to undertake an activity jointly.
39. Joint relationships can be sub-classified and different accounting treatments apply for each type of joint venture as follows:
- (a) *Joint relationships involving operations or activities*, for example, two entities agreeing to undertake a particular activity jointly each contributing their expertise or experience where relevant to the joint objective. Since the reporting entity is undertaking its agreed component of activities using its own resources the reporting entity in its own GPFR accounts for the expenses and liabilities that it incurs in its own name and for its share of benefits derived.
 - (b) *Joint relationships involving assets*, for example, two entities agreeing to share the use of particular assets. The reporting entity recognises in its own GPFR 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 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 relationships involving incorporated entities that have legal form*, for example, two entities holding equal share in a company limited by guarantee. One of the following approaches may be selected:

- (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 entity's post acquisition change in net assets/equity. The reporting entity's statement of financial performance reflects its share of the other entity's post-acquisition surplus or deficit.
- (ii) *Proportionate consolidation*: Under this method, the reporting entity consolidates its share of the assets, liabilities, income and expenses of the other entity.

Associate Relationship

40. A reporting entity's interest in an entity with which it has an associate relationship should be accounted for using the equity method. Under 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 entity's post acquisition change in net assets/equity. The reporting entity's statement of financial performance should reflect its share of the other entity's post-acquisition surplus or deficit.

Insignificant Relationship

41. A reporting entity should account for its interest in an entity with which it has an insignificant relationship in accordance with relevant standards. Given the nature of the relationship and the likely purpose of the other entity, any contribution by the reporting entity to the other entity is likely to be recognised as a donation. The Working Group recommends that the standard should provide guidance on this.

PART D: SUMMARY AND CONCLUSION

42. The Working Group has considered the types of entities that make up the Tier One and Tier Two Not-for-Profit sector of New Zealand. It has also considered the different structures of these entities. This process has led to the identification of the three steps detailed in Part C of this report.
43. The Working Group recognises that a number of different structures exist within these entities and, while they may have similar names (e.g. branch, chapter, division), the relationships between them may be dissimilar. In working through the three steps, a flow chart would be useful to assist charities in their decision-making.
44. The Working Group is available to assist further in the development of the three steps identified and their placement as potentially either a non-integral part of the PBE Standards or as a separate explanatory guide for NFP entities.

PART E: APPENDICES

APPENDIX ONE – FACTORS TO CONSIDER WHEN IDENTIFYING THE BENEFIT ELEMENT

1. Rights that, if they exist, may indicate that the 'benefit' element is satisfied include (but are not limited to):
 - (a) ownership of an interest in the other entity;
 - (b) a right to appoint or remove members of the governing body;
 - (c) an ability to cast votes at meetings of the governing body;
 - (d) an ability to impact employment decisions relating to key management personnel of the entity or another entity that directs the relevant activities; and
 - (e) an ability to influence the revenue-raising, expenditure and resource-allocation policies of another entity or to impact decisions of the governing body of the other entity.

2. Different forms of rights that can arise, but are not common in the NFP sector, include, but not limited to, the following:
 - (a) *Franchise rights*: Franchisors' rights may give the franchisor power to direct or influence franchisees as they may give the franchisor the current ability to direct or influence the activities of the franchisee.
 - (b) *Contractual rights*: A contractual arrangement between a reporting entity and other vote holders can give the reporting entity power to direct or influence another entity.
 - (c) *Other rights*: Other decision-making rights can give a reporting entity power to direct or influence another entity.

3. Other factors that may indicate that the reporting entity has the ability, capacity or right to satisfy the benefit element include the following:
 - (a) In substance, the reporting entity has the ability to benefit from the activities of the other entity.
 - (b) The reporting entity has an ability to direct/influence the other entity to co-operate with it in achieving its objectives.
 - (c) The reporting entity has the ability under existing regulation or other instrument to access resources of the other entity for purposes determined by the reporting entity.
 - (d) The reporting entity has received an undertaking by another entity of an activity involving the supply of goods or services that is directly consistent with, and is likely to enhance, the reporting entity's operating objectives.

- (e) The reporting entity has an ability to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.
 - (f) The reporting entity holds direct or indirect title to the net assets/equity of the other entity, with an on-going right to access these.
 - (g) The reporting entity has a right to the net assets/equity of the other entity in the event of the other entity's liquidation, or in a distribution other than liquidation.
 - (h) The reporting entity has a right to distributed or undistributed surpluses attributable to holders of an interest.
 - (i) The reporting entity has a right to changes in the value of net assets or the rights thereto, excluding contributions and withdrawals of members of that entity.
 - (j) The reporting entity has a right to derive net cash inflows or other economic benefits from an entity under an arrangement which limits that entity to activities consistent with the activities of the entity able to derive the economic benefits.
 - (k) The reporting entity has an ability to access cash flows arising from the operations of the other entity.
 - (l) The reporting entity has an ability to reduce the risk of incurring losses or to limit other financial risks.
4. In assessing whether the reporting entity can achieve its objectives through the capacity to direct/influence the use of the resources of another entity, it is necessary to consider whether the activities over which the reporting entity has this capacity affect the benefits that could be derived from the activities of the other entity. That is, whether those activities are key activities of the other entity. Examples of policies or activities that, depending on the circumstances, need to be considered include (but are not limited to):
- (a) selling and purchasing, for example the nature of and the supply of goods or services is consistent with the objectives of the reporting entity, and as a result of the supply the reporting entity may be or actually is relieved of an actual or constructive obligation to provide such goods and services;
 - (b) management of assets including approval to purchase and sell assets;
 - (c) design of funding structures and obtaining funding, including for example, access to future liquidity;
 - (d) establishing operating and capital budgets, including for example, tax benefits, reduced deficits and synergistic benefits to create economies of scale; and
 - (e) appointing, removing, terminating and remunerating key management or key service providers.

5. The reporting entity must have the practical ability to exercise its decision-making powers at a time that decisions about the key policies of the other entity are made in order for the reporting entity to have a relationship with the other entity based on the benefit criterion. If the reporting entity is not going to receive any benefit (directly or indirectly) it is unlikely to have a relationship for financial reporting purposes with the other entity.

APPENDIX TWO – FACTORS TO CONSIDER WHEN IDENTIFYING TRUSTS AND OTHER “AUTO-PILOT MECHANISMS

1. The existence of any of the indicators contained in this appendix may mean that a reporting entity can direct/influence another entity or assets held outside the reporting entity and therefore the reporting entity should include that entity or those assets in the GPFR.
2. In such cases, the reporting entity may have a relationship with another entity when, in substance:
 - (a) the reporting entity has the capacity to direct the use of benefits of the activities of the other entity under an “autopilot” mechanism. The reporting entity has in effect delegated its capacity and the other entity acts as the agent of the reporting entity; or
 - (b) the reporting entity restricts the activities of the other entity, requiring them to be conducted on behalf of the reporting entity according to its specific needs. Therefore the reporting entity directly or indirectly benefits from the other entity’s operations; or
 - (c) the other entity holds resources on behalf of the reporting entity; or
 - (d) the reporting entity is responsible for the liabilities of the other entity; or
 - (e) the reporting entity retains some residual risks related to the other entity and obtains some benefits from its activities.
3. In each case, judgement must be exercised in the context of all relevant factors. Factors to consider in assessing whether the other entity is in effect on autopilot to the benefit of the reporting entity include the following:
 - (a) the purpose and design of the directed/influenced entities and the risks to which the reporting entity is exposed;.
 - (b) the reporting entity’s degree of involvement in decisions made at inception of another entity;
 - (c) the scope of the other entity’s decision-making capacity, the permitted activities of that entity and the discretion the decision-maker has about those activities;
 - (d) whether the other entity’s financial and operating policies or key decision making is predetermined; and
 - (e) the rights held by other parties in the other entity and other party’s exposure to any associated risk.