Groups and Consolidations – new financial reporting standard challenges for Charities

Control is a very important concept when it comes to financial reporting. If registered charities are in a control relationship, the controlling entity will have to prepare consolidated financial statements, consolidating the financial information of their entity with the financial information of all the entities they control.

This issue is being brought into sharp focus with the introduction of the new mandatory financial reporting standards. We take a high level look at what this means.

Background

Registered charities may have relationships with other entities (whether for-profit, not-for-profit or other registered charities). The nature of these relationships can be complex and/or unclear. The relationships with branches, trusts and affiliates, for example, may resemble “ownership relationships” (for example, where one entity can influence or direct the operation of another, and potentially receive benefits from that other entity). Alternatively, they may operate quite independently from one another but share a common name for the purposes of supporting their cause. Some of these entities may be registered with DIA Charities Services as a group (referred to in the Charities Act as a “single entity”), and some may not.

Some academic research carried out in 2013 by Carolyn Cordery and Jaini Patel from Victoria University found that these related charitable entities register and report in a number of different ways. These researchers found that, in some cases, charities that present and report as a related group did not comprise a “group” as understood in accounting terms. In other cases, individually registered charities were part of a group with other individually registered charities, but did not register or report as such. The researchers found that the reporting by these charities could confuse users who are either presented with financial statements of a disparate set of charities, or who (if they know there are other charities which form part of a group) must search the register to locate associated charities. The researchers, none too surprisingly, concluded that the lack of clarity in this area is a concern.

As auditors and advisors to a wide range of charities, our experience and anecdotal evidence completely confirms the views of the academic researchers.

We are also aware of a reasonably common “game” in the NFP/charitable sector called “We can’t afford to look rich otherwise we won’t get funding. Let’s set up another entity”. In essence the fear, irrational or otherwise, of adverse funder reaction has led many NFP or charities to set up new legal entities such as trusts and foundations to move funds out of their financial statements. Not surprisingly in many if not most cases these other entities are in fact controlled in an accounting definition of the term. Hence the new accounting standards in relation to control set out to ensure they are consolidated so that stakeholders get the true picture of the overall organisation’s assets.

The new financial reporting standards, which are mandatory for registered charities, should help to improve transparency in this area. However, this will require greatly improved awareness, understanding, and for some groups, potentially some significant structural and/or mind-set changes.

What’s required under the new financial reporting standards in terms of group reporting?

Under the new financial reporting standards as part of the entity and service performance information required, registered charities will have to provide a description of their operations including entity structure and governance arrangements. Note that while some of this information is only currently required for Tier 3 and 4 charities, it will be a requirement for tiers 1 and 2 in future. Including this information will improve visibility and clarity about what the charity consists of (e.g. any branches). For the purposes of financial reporting, branches would be considered part of the 'reporting entity' and the charity would need to include information about them in their performance report and consolidated financial statements.

Some charities set up separate organisations to carry out their different activities. For example, a charity might establish a separate trust to manage its properties and investments, or establish an incorporated society to run a second-hand shop that provides income for the charity. In these situations, the charity is likely to have a 'control relationship' with the trust or incorporated society. Under the new financial reporting standards, if one registered charity controls another entity (whether it is a registered charity or not), the standards require the controlling entity to prepare consolidated financial information.

The definition of control in the financial reporting standards is quite specific. Frustratingly for many trying to get their heads around this is that the definition can be different from what many would "ordinarily" consider control. It is also often different from the legal definition of control. Hence it is perfectly understandable that some organisations become confused to be receiving apparently contradictory advice from different groups of professionals.

Control in financial reporting standards relates just to financial reporting. It means "the power to govern the financial and operating policies of another entity so as to benefit from its activities". Control therefore has two elements – the power element and the benefit element. Both must generally be present. Determining whether charities have this control relationship can be complex.

The XRB has developed useful guidance on both of these matters, and there is further information on the DIA Charities Services website. However, in addition to this there is in many cases a need to seek specific accounting advice in relation the circumstances of a particular charity/group.

The tests for control in accounting terms are not black and white. Rather it is more a weight of evidence of the shades of grey type of test. The reality is that this is often not easy. But interestingly having to go through the process often tends to uncover interesting and subjective control relationships that perhaps have not been as clearly spelt out as they ideally should have been in the past. In essence the consideration for financial reporting purposes forces some important relationships and issues to be addressed.

What is this likely to mean for registered charities?

Charities will need to consider and clearly understand what makes up their reporting entity, and whether they have any relationships for financial reporting purposes. This will be important for:

The charity's compliance with the new mandatory financial reporting standards – these standards are legal instruments and hence any non-compliance (such as non-consolidation) is in effect breaking the law.

Their reporting to DIA Charities Services – at present there is a potential mismatch between what will be required in terms of consolidation of controlled entity from the perspective of the new financial reporting standards and how a charity group can be registered and report on the DIA Charites Services website.

Potential strategic and governance considerations and whether the new financial reporting changes are a prompt for possible legal restructuring of registered charity entities and their group structure. Such strategic restructuring considerations may provide benefits by helping to address a range of other current challenges around compliance costs and operations.

For some groups there will also be potential issues with the alignment of accounting treatment across the members of the group – particularly if smaller charities that have previously not reported under generally accepted accounting practice are now to be reported in the new "group" financial statements. There may also be practical challenges for in-house or external accountants in respect of obtaining the financial information in a format that will easily facilitate the consolidation process, (which will also require the identification and elimination of intra-group transactions). Particularly complex consolidations may require new skills to be developed by in-house finance people, or alternatively outsourced to external accountants.

Where to from here?

The time to start to consider this issue is now, as the compulsory adoption of these standards is for accounting periods commencing after 1 April 2015. Logically this should be done firstly by the charity/group as determining what other entities does it control should be at the core of its strategic understanding as an organisation. However we would also suggest that involving your accountants and auditors at an early stage is advisable in respect of the application of the requirements of the financial reporting standards to the particular circumstances.

The impact of this ranges from being a “non-event”, to a “game-changer”, and everything in between. We look forward to continuing to provide helpful information and expert services to the sector and to being of service.

About the Author

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