Charities: reporting on solvency and liquidity risks

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Naziar joined Crowe in September 2008 from a Big Four Firm as a specialist Non Profits partner and is now Head of Non Profits.

In addition to providing assurance services she also provides advisory services to a range of charities. These include assignments from risk and finance function reviews, systems, benchmarking and performance measurements and governance reviews.

Naziar leads Crowe's work on Donor Audits and has knowledge of institutional funding requirements having produced reports for a variety of institutional and governmental donors. Naziar also carries out training for charities and lectures and writes on a range of topics relevant to Trustees and management.

In the uncertain economic conditions of the past few years there has necessarily been a greater emphasis across the charity sector on financial monitoring and, in particular, on ensuring that the going concern assumption in the preparation of period end accounts continues to be valid. This has perhaps been heightened by recent high profile cases of charities with financial problems such as Kids Company.

In 2012 the Sharman Inquiry, which was established by the Financial Reporting Council ("FRC"), published a report on Going Concern and Liquidity Risks. In response to this report, in September 2014, the FRC updated the UK Corporate Governance Code.

To bring together the requirements of company law, accounting standards, auditing standards, other regulation and existing FRC guidance, in April 2016 the FRC issued guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks for companies that do not apply the UK Corporate Governance Code. This guidance replaces the one which was issued in 2009. Whilst this guidance refers to "directors" and "companies", the report makes it clear that it is designed to relate to all other entities preparing accounts under the going concern basis and it will therefore be applicable to charities and charity trustees.

Solvency and liquidity risk guidance

The guidance defines Solvency Risk as "the risk that a company will be unable to meet its liabilities in full" and Liquidity Risk as "the risk that a company will be unable to meet its liabilities as they fall due". Although compliance with the new guidance is not proposed to be mandatory, it is anticipated that it is best practice for all entities other than those that are small. Trustees of larger charities will therefore be expected to follow the guidance.

The tenor of the guidance is to encourage directors to think broadly about risk and uncertainties including a focus on solvency and liquidity. It also aims to improve reporting on the going concern basis of accounting by linking this reporting with the material uncertainties and principal risks. Importantly the guidance encourages directors to take a broader longer term view and go beyond the specific requirements in accounting standards.

Reporting considerations for charities

The guidance links well with SORP 2015 which requires charity trustees in their annual report to disclose uncertainties about the charity's ability to continue as a going concern and explain the nature of these uncertainties. SORP 2015 also requires trustees to disclose the principal risks and uncertainties facing the charity and an explanation of how the charity manages these, including a brief explanation about those factors that support the conclusion that the charity is a going concern. Furthermore, where there are no material uncertainties about the charity's ability to continue, this should be stated. The guidance for the first time explicitly states that "Directors should consider threats to solvency and liquidity as part of their assessment of risks and uncertainties faced by the company".

The information on risks and uncertainties will also need to link in with the required disclosures on the amount of the charity's reserves and why they are held or, if no reserves are held, the reasons for this. There is additionally the requirement to compare the amount of reserves held with the charity's reserves policy and explain, where relevant, what steps the trustees are taking to bring the amount of reserves the charity holds into line with the level of reserves identified by the trustees as being appropriate.

Whilst the guidance notes that the period of assessment will ultimately be a matter of judgement for the directors and will depend on the facts and circumstances of the company, it goes on to state that "except in rare circumstances it should be significantly longer than 12 months from the approval of the financial statements".

It is perhaps worth noting that a recent report reviewing some major UK companies' reporting found that, in tackling the new Corporate Code provisions on risk, internal control and viability, the majority of UK companies were for the long term viability statement considering a three year look out period.

Risk factors to consider

The guidance sets out some of the factors which directors should consider as part of their assessment process but also explains that it is the directors that need to determine the relevance of these factors considering the size, complexity and the particular circumstances of the organisation, its industry and the general economic conditions. The factors suggested are:

- forecasts and budgets
- timing of cash flows
- sensitivity analysis
- products, services and markets
- financial and operational risk management
- borrowing facilities
- contingent liabilities
- subsidiary companies
- companies dependent on the government.

In addition there may be charity specific issues to consider including ensuring that there are no breaches of trust with respect to any restricted income or endowed funds and that the charity is able to meet its obligations in relation to these funds. Trustees may be held liable for a breach of trust if they apply restricted funds for purposes outside of the relevant restriction.

The Charity Commission in their guidance Managing financial difficulties & insolvency in charities" (CC12) explain: "It is important for planning purposes that the trustees are aware of the ways in which their charity's assets and resources can be used. Some funds can be used for all of a charity's purposes and some have restrictions on use placed on them by their donors. An understanding of the nature of the separate funds of a charity is crucial to the understanding of its financial position. Such considerations must be taken into account when analysing and assessing the solvency of a charity. It is a breach of trust to use endowment or restricted funds for purposes other than those for which they were given by the donor."

Many charities rely on unpredictable income streams such as donations, legacies or grant funding much of which is under pressure. Increasingly grants and other funding are being based on payment related to results with cash being received after expenditure has been incurred by the charity. This can put pressure on the charity's available liquid resources and increase the liquidity risks. The variability in available funding may also lead to charities having to dip into their unrestricted funds to maintain their current provision of services or to invest in future income generation.

There have been of late been some high profile cases of charities going into liquidation. For example, in their report on its operational compliance case into BeatBullying, the regulator says the charity, which went into liquidation, had no reserves and was "quickly affected by the cancellation of anticipated funding". More

recently the Charity Commission has started a statutory inquiry into Kids Company. At Kids Company, free reserves were very low which coupled with the fundamental risks arising from its demand led business model led to its collapse at the first hint of reputational trouble.
There is no one size fits all yardstick for charity reserves but to set an effective reserves policy trustees must link reserves with the risk management and forecasting process and consider the charity's operating realities.

There is much that charities can do to avoid a solvency or liquidity crisis. As with most businesses the key focus should be on careful cash management. Good management information is vital and it is important to reassess how a charity identifies what is key to its financial management and records and reports on what matters. Consideration of funding streams, the timing of cash flows and the risk of extensive pre-financing needs to be carefully monitored. Additionally there should be regular reviews of the overall risks facing the charity as well as a regular review of its reserves and reserves policy.

Trustee reporting

A good Trustees' Report provides a clear linking of the aims, objectives, achievements and performance explanations within the Trustees' report to the financial statements. A good report will have a clear thread of reporting between the charity's objectives and activities, achievements and performance and its plans for future periods. It should also include information about the resources the charity needs if it to be able to achieve its goals.

With regard to disclosures, the guidance reiterates as best practice that "when there are material uncertainties that may cast doubt upon the company's ability to continue to adopt the going concern basis of accounting in the future, the financial statements should disclose clearly the existence and nature of the material uncertainty, including a description of the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and the directors' plans to deal with these events or conditions. Directors may wish to bear in mind the obligation of the auditor to report if an appropriate level of clarity in the disclosure of material uncertainties has not been achieved."

There are important implications for the auditor's report where the auditor concludes that a material uncertainty exists and therefore the point regarding obligations of auditors is expanded in a separate section intended to assist directors understand the responsibilities that the auditor has in connection with the directors' assessment of the company's ability to continue to adopt the going concern basis of accounting and related disclosures in the financial statements or annual report.

The FRC guidance reiterates this point by stating that "Directors should consider the placement of disclosures with a view to facilitating the effective communication of that information". It discusses grouping of similar or related disclosures to reduce duplication and enable linkage and the use of cross references.

The guidance refers to signposting as "a means by which a user's attention can be drawn to complementary information that is related to a matter disclosed in a component of the annual report". Although a charity must continue to meet its legal and regulatory disclosure requirements in the various parts of its annual report and financial statements, the use of signposting to link this information may be a way in which Trustees can improve their overall reporting.

We have for some time seen trends towards better clearer reporting by companies and charities alike. There continues to be a movement towards linking the various strands of reporting by charities and towards linking the narrative with the numbers as a means of explaining what the charity has done with the resources entrusted to it. The improved reporting on the solvency and liquidity position of a charity is becoming an expected and important part of this narrative.

Start the conversation

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