The Virtues and Risks of Poverty

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Not-for-profit organisations that seek money from donors or funders are at times disadvantaged if their financial accounts show a surplus. This article will consider the virtues and risks of poverty i.e. having financial accounts that show a deficit or a very minimal surplus.

Virtues of Poverty:

One of the virtues of poverty is that looking poor can attract funds from donors and funders. Generally, not-for-profits that are seeking donations from the general public do not want to look rich, i.e. display a large surplus or conspicuous assets, as this raises questions as to the need for further donations.

Some not-for-profits actively ensure that their financial accounts do not show a surplus by separating out some profitable activities into a separate organisation which are not included in consolidation. By creating subsidiaries, it is possible to hide assets and surpluses.

Subsidiaries off-balance sheet appears to be in breach of the New Zealand Equivalent to International Accounting Standard 27 Consolidated and Separate Financial Statements (NZ IAS 27). The objective of NZ IAS 27 is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control.

The New Zealand Institute of Chartered Accountants' (NZICA) Not-for-profit Sector Advisory Committee (NFPSAC) has been grappling with the issue of control for not-for-profits. Especially in relation to the recent Exposure Draft 10 Consolidated Financial Statements (ED10) which defines control as:

"*When the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity."*

The notion of "returns" is possibly not relevant for not-for-profits. This means that in spite of NZICA's emphasis on sector neutrality not-for-profits could argue that none of their entities are generating "returns" in the sense of profit, for the reporting entity so therefore there is no need to consolidate off-balance sheet.

Separate legal entities

In New Zealand we researched not-for-profits and found that some not-for-profits are largely unaware that the legal and accounting notion of ownership is different, that is a separate legal entity is not necessarily a separate accounting entity. Some are receptive, but possibly indifferent, to consolidating their various entities and are not concerned with giving the readers of their financial statements the whole picture.

However, we also identified that other not-for-profits have tried to actively hide either assets or income. A technique for doing this is to use the legal vehicles of an incorporated society and a charitable trust. For example, one incorporated society had a building from which it earned income. They were concerned that this would make them attractive to be "taken over" by members who did not follow their philosophy. So they removed the building into a separate Charitable Trust over which the Incorporated Society supposedly had no control. The trustees have the option not to donate monies to the incorporated society which means the incorporated society becomes dependent on the trust. Such techniques raise interesting questions of control.

The practice of hiding assets and income is facilitated by the relevant registry which requires financial accounts for Incorporated Societies but not Charitable Trusts. However, if these entities choose to register as a charity it is hoped that the public availability of both sets of financial accounts could help reveal hidden assets provided that members and donors know where to look (http://www.register.charities.govt.nz/CharitiesRegister/Search.aspx).

In France, the CRC 99-02 code (*Comité de la Réglementation Comptable*, 2004) also requires charities to consolidate subsidiaries where there is control. Yet, despite the regulations, the *Observatoire KPMG* (footnote 1) (2007) report that from their survey of large French charities, 26% that should consolidate did not, and a further 52% did so in a manner leaving much scope for improvement.

Research conducted by one of the authors in France also found that among small-medium sized charities there is a desire to keep the incomes within the €153,000 limit (beyond this sum charities are obliged to provide accounts to the local prefecture and employ an external auditor), with the result that a practice has developed of creating subsidiaries or affiliated associations specializing in some part of the charity's activities. In this way, incomes are kept within the limit.

Categorise surplus into restricted and unrestricted

Research by the authors was conducted among New Zealand Incorporated Societies to discover whether the separation of a surplus, between restricted and unrestricted, would be useful. We considered that this separation would be useful for not-for-profits who had a large portion of their surplus restricted i.e. only allowed to be used for a particular purpose. Separation would highlight the relative 'poverty' of the not-for-profit in relation to their unrestricted surplus.

In our research, four hundred incorporated societies were surveyed on whether they had any funds of a restricted nature. If they did, the survey asked, whether they disclose, or would they consider, disclosing these funds separately. Of those surveyed seventy percent considered that it is very useful to separate disclosure of funds with different natures for three main reasons: (1) offered increased transparency of funds in their organisations; (2) better information on funds used; and (3) was an aid in explaining their need for funds to the fund providers when they apply for funds. However, by contrast sixty-five percent of those surveyed consider that while it was useful to separate out funds they would not change from their current structure. Some of the key reasons included that their current format was adequate and familiar.

It may be more useful to simply apply the matching concept. Matching has its roots in the economic premise that sacrifices must generally be made (costs must generally be incurred) to achieve benefits (revenues). A good example for not-for-profits could be where donations are received for constructing a building which has not yet been built. In which case the donations received for the building would be transferred to liabilities thus decreasing any surplus.

Risks of Poverty

While we have considered the virtue of poverty in attracting funds there is also the risk for donors in being attracted to badly managed not-for-profits. This can lead to donors wanting to fund not-for-profits who have poor governance and possibly poor sustainability. Thus sustainable not-for-profits who are budgeting well and consequently have a surplus are disadvantaged against their badly governed and impecunious counterparts.

Laying down a challenge

It is important for both funders and potential donors not to disadvantage not-for-profits who are budgeting well in favour of not-for-profits who are crying poverty. There is a need for accounts to be examined on a contextual basis to gain a full appreciation of the not-for-profits ability to meet their mission whether that be feeding the hungry or providing sporting facilities.

Footnote

1. Observatoire KPMG (2007) *Transparence et Associations* available from: http://www.kpmg.fr/FR/publication/?id=427869293756304857573366443674 58