2014

MHA Top 10 Issues for the Charity and Not for Profit Sector

Report

Introduction

Welcome to the MHA Top 10 issues for the Charity and Not for Profit (NfP) Sector.

This report has been collated to offer guidance and support to Finance teams, Trustees and the Senior Management teams across a number of relevant and timely issues for those in the Not for Profit sector.

The sector is dealing with continued challenges from numerous directions. Changing legislation is placing a cost burden onto organisations already struggling with funding issues. Governance continues to be key in maintaining and developing a successful organisation, being alive to taxation issues has become imperative and the charity regulators (Charity Commission and the Office of the Scottish Charity Regulator (OSCR)) are adopting a more rigorous approach.

The individual firms within MHA deal with hundreds of these issues on a regular basis, all specific to the charitable sector and in this report we've tried to focus on the top ten issues that are raised regularly by our client base of over 1600 charity and Not for Profit organisations.

We have brought these issues together to allow you to dip in and out as the need arises or to use as a useful update for those looking to refresh or further their knowledge.

We hope that the areas we have focused on will provide guidance and support, allowing you to concentrate on the objectives of your organisation. Our specialist advisors to the Not for Profit sector are able to draw on a vast wealth of experience and expertise encompassing the full range of NfP organisations including charities, social enterprises, education, housing and public sector.

If you have any questions about the issues raised in this report or would like to discuss your accounting needs with one of our sector specialists please do not hesitate to contact your local MHA member firm.

info@mha-uk.com

The Top Ten Issues

Legislation

1. SORP/FRS102
2. Auto-enrolment
3. Gift Aid
4. VAT awareness
5. Charity trading subsidiaries

Governance

6. Risks and trustee responsibilities
7. Charity trustees and conflicts of interest
8. Trustees and the art of delegation
9. Reserves
10. Fraud

Legislation

1. SORP / FRS 102

Simon Erskine, DChA

MHA member firm – MHA MacIntyre Hudson

The new Charities SORPs (Statements Of Recommended Practices for Charities) were released in July 2014 and will come into force, in line with the new UK Generally Accepted Accounting Practice (UK GAAP), for accounting periods starting on or after 1 January 2015 (early adoption is not permitted).

This is perhaps one of the biggest current challenges that all charitable organisations preparing accrual accounts in the UK will need to be ready to deal with. Speaking with charity clients across the MHA member firms it's certainly the biggest issue that their FDs currently have to consider.

The biggest change from the current SORP 2005 is that there are now two SORPs – Charities SORP (FRSSE) and Charities SORP (FRS 102) – reflecting the two different accounting frameworks that will apply to charities from 1 January 2015. The FRSSE (Financial Reporting Standard for Smaller Entities) is essentially a cut-down version of current UK GAAP. For accounting periods starting on or after 1 January 2015, however, UK GAAP is, for most organisations, going to be a much simpler, but significantly different, set of rules called FRS 102, which is based on international accounting standards. With the FRSSE and FRS 102 representing completely different accounting frameworks it was decided that two different SORPs were necessary.

Smaller charities eligible to use the FRSSE can opt to apply FRS 102 and the corresponding SORP.

While FRS 102 deals with some relatively sophisticated concepts, such as discounting long-term assets and liabilities and complex financial instruments, there are also simpler, but far-reaching, changes such as the recognition criteria for income – where the requirement for "virtually certain" has been replaced by "probable" (more likely than not), which is likely to lead to earlier recognition of income, particularly in areas such as legacies and donated goods.

Legislation

FRS 102 brings into UK GAAP for the first time specific requirements for public benefit entities (PBEs) and, while FRSSE 2015 (the version of FRSSE applying when the new UK GAAP comes into force) is largely unchanged from the current version, one key change is the requirement to apply the PBE provisions from FRS 102.

As a result, some of the main new provisions in the SORPs, covering areas such as donations, legacies and concessionary loans, are identical in both.

One key change in the new SORPs is the move to distinguish between compulsory accounting policies (and disclosures) and recommended practice or simple suggestions.

The FRS 102 SORP now makes it clear that in future, liabilities for these deficit reduction payments will need to be accrued in the accounts.

This is done by using the three words "must", "should" and "may". These words are used liberally in the new SORPs and have their normal meanings.

It is therefore important to read carefully, because only the "must" points are mandatory.

There is a clearer distinction in the Trustees Annual Report (TAR) between those disclosures required for all charities and those which only apply to larger charities over the charity audit threshold (income of £500,000, or £250,000 for charities with aggregate assets of £3.26 million) by including the latter provisions in a separate part of the TAR section (which is identical in both SORPs). This includes changes on risk disclosures and disclosures on reserves, along with a recommended emphasis on impact reporting. Larger charities need to disclose the arrangements for setting the pay and remuneration of the charity's key management personnel (essentially trustees and senior management).

The new SORPs simplify the Statement of Financial Activities (SOFA) – with the number of expenditure headings reduced from seven to just three. In particular "Governance costs" disappears from the face of the SOFA, instead being disclosed as part of Support costs and allocated across all activities. The other big change to the SOFA derives from FRS 102 which includes investment gains/losses as a revenue item. The changes to the SOFA in the FRSSE SORP are generally less dramatic.

Indeed, for those charities below the charity audit threshold which opt to use the natural classification (e.g. Staff costs, Rent etc.) rather than activities (Raising funds, Charitable activities) the only significant change is the requirement to disclose comparative figures for all amounts including restricted and unrestricted funds. This latter change affects all charities and, given the difficulty of including 6 or more columns on one page, is likely to result in a prior year SOFA being included in the notes to the accounts.

There are no substantive changes to the format of the balance sheet in the new SORP but changes in accounting principles will have an effect on the numbers – in some cases quite substantially. For example, under SORP 2005 and current UK GAAP many charities and auditors consider that there is no requirement to include in the balance sheet any liability for agreed deficit reduction payments for multi-employer pension schemes, such as those run by the Pensions Trust, where it is not possible to separately identify the individual charities' share of the scheme assets and liabilities. The FRS 102 SORP now makes it clear that in future, liabilities for these deficit reduction payments will need to be accrued in the accounts. This will have, in many cases, a significant impact on free reserves. There is no change for charities applying the FRSSE SORP, at least for the time being, until the FRSSE is brought into line with FRS 102 principles.

Cash-flow statements have been simplified and are not required for entities applying the FRSSE. Unlike the current situation, however, where small charities are exempt from the requirement to prepare a cash-flow (even when not applying the FRSSE), all charities applying FRS 102 will need to prepare a statement of cash flows, regardless of their size. Small charities wishing to avoid this requirement will need to apply the FRSSE.

The definition of related parties has changed significantly (it is the same in both new SORPs) and we consider that, although still complex, it is more user-friendly than the SORP 2005 definition. There is a new requirement in the FRS 102 SORP to disclose, for the first time, the aggregate of donations received from trustees where they do not include conditions that would require them to be separately disclosed. Aggregate remuneration for key management also needs to be disclosed.

This article can only be an introduction to the new SORPs, which each run to approximately 200 pages. For those wishing to delve more deeply please contact your local MHA member firm.

The Charity Commission or OSCR also has plenty of resources on the SORP microsite www.charitysorp.org including the full text of both SORPs and help sheets.

To discuss these issues in more detail please contact your local MHA firm.

2. Auto-enrolment

Simon Brown, DChA

MHA member firm – Tait Walker

Between 2012 and 2016 every organisation in the UK will be impacted by Pensions Reform legislation. At MHA we believe that Auto-enrolment is not just a pensions issue but will impact upon charities costs for employment and is also a management and compliance issue.

For charities that have a well developed pension scheme in place, the reforms may just lead to minor adjustments. At the other end of the scale, charities that presently have no pension provisions in place will need to prepare now for what may be a significant impact.

MHA's specialist teams can help guide you through the challenge of Auto-enrolment and make sure that your charity complies with the new rules in time and in the most cost effective way.

If your charity employs staff, you will need to enrol all your eligible workers into a pension scheme and make a contribution towards it.

Workers employed and paid by the charity for the work they do are eligible for pensions if they:

- earn more than the current minimum wage
- are aged between 22 and the state pension age
- work in the UK

'Workers' include contractors and agency staff, as well as people working under an apprenticeship. Volunteers and unpaid staff are not eligible.

Legislation

10 key questions you should know the answer to are detailed below:

Do you know your staging date?

If you have not already done so you can find out your staging date via the pensions regulator web site **(www.pensionsregulator.gov.uk).** You will need your PAYE reference to find out your staging date.

Charities with fewer than 50 staff can choose to move their staging date to between 1 August 2015 and 1 April 2017.

If you are within 12 months of your staging date you should already be planning for Auto-enrolment, if not you need to start immediately!

If you are within 6 months of your staging date, some pension providers will not offer you a scheme because they may consider this to be insufficient time to address all of the actions required.

The Pensions Regulator will contact employers from between 6 and 12 months prior to their staging date.

Do you know if your current scheme is compliant?

Many charity pension schemes will meet the new requirements and qualify. If your current scheme doesn't qualify then you may be able to make some changes and qualify before your staging date.

Your current scheme may not be considered "fit for purpose" or able to support auto enrolment. Non-compliance can bring fines of up to £10,000 per day! If any changes need to be made to your current pension scheme, these must be discussed and agreed by the charity's trustees'.

Do you know that Auto-enrolment is "opt out" not "opt in"

Many employers and employees do not know that staff will have to be automatically enrolled into a new scheme if the current scheme does not qualify.

Many employers are not planning for the 'true financial impact' of Auto-enrolment, some are planning for staff who may "opt in" when in reality employers will need to make contributions for the majority of all of their workers.

Do you know that pension providers can 'cherry pick' schemes and do not have to accept your scheme?

Pension providers are a business like any other; they want to work with the most profitable schemes. If you don't start planning early you may find that you are left with very few options. Your scheme may be turned down if it doesn't reach pension providers 'profitable' criteria!

Have you planned how you will communicate the changes to your workers?

Not fully explaining the process and impact of Auto-enrolment clearly to workers can cause some employment issues and confusion. How will your staff react if pension contributions replace an expected pay rise? Or your scheme is not as good as your competitors? If your staff do not understand the changes or the employee benefit scheme they are part of, this could have a very negative impact.

Do you know how much Auto-enrolment will 'cost' per employee?

Many employers are not aware there are ways to reduce Auto-enrolment costs by identifying the lowest measure of qualifying earnings that are pensionable and by using salary sacrifice arrangements to reduce employers NIC.

Do you understand how NEST works?

Unless an employer has a 'qualifying pension scheme' in place, the employer will have to auto enrol eligible jobholders into the National Employment Savings Trust (or NEST), which is to be run by NEST Corporation, a trustee body set up for the purpose.

You can find out more about NEST at: **www.nestpensions.org.uk/schemeweb/NestWeb/public/whatIsNEST/contents/what-is-nest.html**

NEST may provide a solution to those who are unable to organise a scheme but it is not always the best option and can mean lots of additional time costs for an employer.

Legislation

10 key questions you should know the answer to are detailed below:

Are you aware that there are NEST alternatives?

There are alternative solutions to the NEST scheme offering which may provide more flexible options for your charitable organisation.

There are viable alternatives such as 'Peoples Pension' and 'Now Pension' which could be a better option if your organisation is unable to secure a scheme, but you will need to consider how you will review your options.

Do you know how to deal with leavers, joiners and those who "opt out"?

Auto-enrolment is an ongoing compliance issue not just an initial set up process. Not being fully compliant can come with large fines so employers need to get it right. Did you know those who opt out need to be opted back in after 3 years? What is your strategy for tracking leavers and joiners?

Are you prepared for over 200 administrative duties?

As an employer you are faced with over 200 duties in relation to planning, implementation and ongoing maintenance if you choose to administer a scheme yourself.

The additional administration costs and the financial implications of getting it wrong can be substantial. Charities need to plan ahead and not let their staging date draw too close. These dates have been set with reference to your workforce size as at April 2012.

Summary of immediate action points

Charities, especially smaller ones not used to dealing with pension matters, should not be put off preparing for the reforms.

The immediate actions to take include:

- find out what the staging date is for your charity or organisation;
- consider the financial pressures of a sustained pension scheme, the implications for charitable reserves and how your commitment may change over the next few years, compared to now;
- prepare an implementation plan, to include ascertaining how well any existing pension scheme provision meets the new requirements and what changes may be necessary; and
- make sure that trustees / leadership are kept informed on developments in a timely way.

To discuss these issues in more detail please contact your local MHA firm.

Legislation

3. Gift Aid

Linda Boss, DChA

MHA member firm – Monahans

Gift Aid is a way for charities to increase the value of monetary gifts from UK taxpayers by claiming back the basic rate tax paid by the donor on the donation. It can increase the value of donations by a quarter at no extra cost to the donor. Gift Aid is worth nearly £1 billion a year to charities and their donors.

How it works

Charities can reclaim tax from HM Revenue & Customs (HMRC) on the 'gross' equivalent of donations. You can work out the amount of tax you can reclaim by dividing the amount donated by four. This means that for every £1 donated, you can claim an extra 25 pence.

If a donor is a higher or additional rate taxpayer, they too can benefit from tax relief as they can claim relief equal to the difference between the higher rate of tax at 40% or 45% and the basic rate of tax at 20% on the total value of the donation - a total of 20% and/or 25%.

So if £1 was donated, the 'grossed up' donation would be £1.25 and a donor liable at the 40% tax rate could claim relief of 25 pence (20% of £1.25).

It is very important that in any income tax year (6 April to the following 5 April) the donor must have paid enough UK tax to cover all Gift Aid claimed on their gifts in that year. If the donor makes Gift Aided donations to several charities, their tax paid must cover the Gift Aid reclaimed by all of the charities. You as a charity are not expected to police this but you must make it clear to donors that if this is not the case, HMRC may require them to pay any shortfall.

Legislation

Payments that qualify for Gift Aid

Gift Aid is only available for monetary donations subject to very few specific exceptions.

Payments that don't qualify include:

- Donations of money from a company
- A loan made to your charity which is later waived by the individual
- Any gifts which have conditions attached e.g. that the money must be repaid, or that the charity must buy goods or services from the donor
- Payments in return for something e.g. admission to a concert, for a raffle ticket or as an entrance fee for an event

Benefits to donors

A basic principle underlying Gift Aid is that the gift should be freely given with nothing substantial provided in return. However, your charity can give donors modest tokens of appreciation but there are limits on their value:

Amount of donation	Maximum value of benefits
£0 - £100	25% of the donation
£101 - £1,000	£25
£1,001+ (post 4 April 2011)	5% of the donation up to a maximum of £2,500

The way in which the benefit value for individual donors is calculated can be tricky, so do seek advice from your professional advisor if you would like help with this.

Gift Aid Declarations

A donor must provide the charity with a declaration that their donation is made under Gift Aid. This declaration can be in writing (including by e-mail, text message or a web form) or orally (usually over the telephone). A written declaration must include the donor's name, address (minimum of house number and post code), identity of charity they are donating to and identification of the gift to which the declaration relates. HMRC has standard Gift Aid declaration forms on its website so these can be used as a useful template for the information required.

The individual donations on your Gift Aid tax reclaim to HMRC must be traceable back to a record of the original declaration, together with confirmation from the donor that they have paid at least as much tax in the tax year as can be reclaimed on their gift. HMRC conduct periodic audits of Gift Aid claims so you should ensure that your Gift Aid audit trail and documentation is sufficiently robust for such a visit.

As well as straight forward donations there are other circumstances where you can use Gift Aid to increase the money received by your charity.

Legislation

Claiming tax back

You don't have to register with The Charity Commission or OSCR to claim Gift Aid but your organisation must be recognised by HMRC as a charity for tax purposes before HMRC will accept a Gift Aid claim. Recognition by HMRC as a charity is a separate process from registering with The Charity Commission or OSCR.

Once HMRC have accepted that you are a charity for their purposes, then there are three ways for you to claim tax repayments:

- You can use an online form to file your repayment claim. You'll need to add information about the donations your charity receives onto a spreadsheet, and attach it to your online claim form. To use the online claim form, your organisation needs to sign up to use HMRC Online Services, and enrol for the Charities Online service.
- If you want to make large claims, you can also use external software to file claims directly from your own database.
- You can submit claims using a paper repayment claim form, Form ChR1 which you can order from HMRC Charities Helpline. You must use an original form for each claim and don't use photocopies as HMRC won't be able to process them.

Special situations

As well as straight forward donations there are other circumstances where you can use Gift Aid to increase the money received by your charity. These include:

Charity Events

The payment for tickets to an event which you have organised, such as a dinner or concert, does not qualify for Gift Aid as the ticket price is not a voluntary donation. However, if you set a ticket price and then ask for a 'suggested donation' then the donation will qualify for Gift Aid as long as the event can be attended without making the donation and preference must not be given to those who have made the donation.

Activity fundraising

There the question often revolves around whether the participant is receiving a benefit. If someone has decided to run the London Marathon on your behalf and they pay their own entrance fee, then they have not received any benefit and any sponsorship payments received from their family and friends can qualify for Gift Aid as long as the minimum information for Gift Claims has been collected.

If however the participant applies to run the marathon through a charity which pays the entrance fee on their behalf, then they may have breached the benefits to donors rules. Unless they contribute towards the charity's costs for him to enter the race to ensure that the benefits to donors rule is not breached, none of the sponsorship payments made by persons connected to them will qualify for Gift Aid.

Membership subscriptions

To qualify for Gift Aid, any subscription payments must be for membership only and not allow the personal use of facilities for free or at a discounted rate compared to those not paying a subscription. Benefits that can be given and Gift Aid claimed, include receiving periodic newsletters, taking part in activities which form part of the charity objectives or visiting and viewing the work of your charity.

Many of the above fund raising activities can have other complications including VAT so do always seek professional advice when planning these.

To discuss these issues in more detail please contact your local MHA member firm.

4. VAT awareness

Julie Grimmer, DChA

MHA member firm – Larking Gowen

For the VAT-conscious charity Finance teams or CEO, VAT presents a series of challenges with many quite complicated issues. As an area of frustration and mis-understanding for many clients across MHA we will take you through some of the most important ones to consider through a series of questions.

Some initial points:

There is no general VAT relief for charities, and the few specific reliefs that are available are tightly defined. Also as soon as a charity does anything for which it receives any payment or consideration in any form, that is most likely to be deemed to be a business transaction for VAT purposes and the charity will therefore be treated just like any other business, with no concessions. Errors by the charity taxpayer are penalised just as severely as for other bodies. So keeping up to speed with the latest thinking of HMRC and the Courts is another necessity; and prudent planning can make a vital difference.

Legislation

Do you understand the VAT liability of all your sources of income?

These can include standard rating, reduced rating, zero rating (the three types of "taxable" supplies); and also exempt and outside the scope. Getting this right is crucial at the outset because at the very least it will tell you whether, and when, your charity is required to register for VAT, based on your true level of taxable turnover.

Are there any "borderline" sources of income where the liability is unclear and might be questioned by HMRC?

These can include:

- Grant income: A notoriously difficult area where even the Courts often fail to agree. Case law is still evolving, and the form and description of the process - whether as a "grant" or a payment under a contract for services – will not necessarily point you to the correct answer.
- Membership subscriptions: Also a very complex area which is often misunderstood – even by HMRC officers.
- Sponsorship: This means the sponsor provides a benefit, which may be in monetary or other forms; but usually also receives something in return. This brings the sponsorship within the scope of VAT, and you have to identify the nature of what you are giving in return in order to establish the VAT liability. So getting sponsored might come with a VAT cost – if you are not careful enough.
- Donations: If freely given, these are outside the scope. But you have to be sure they are not tied in with any requirement to give something in return. Also they can still affect your input tax recovery if you have costs directly related to generating the donative income.

Do you have any property interests?

Are you receiving income from rents? Are they exempt or taxable? Do you know why? Is the liability correct? Has your charity carried out any major property purchase, alteration or refurbishment within the last 10 years? Why is it important to know this? When can you get VAT relief yourselves on any property rents you are paying?

Do you fully understand the impact of outside the scope activities and exempt income on your entitlement to input tax recovery?

In brief, both are likely to cause some of your input tax to be lost. The normal approach is by applying two processes: firstly filtering out any VAT incurred on non-business operations such as the provision of free services, and then also filtering out any VAT incurred on exempt business activities such as property rental and certain education, health or welfare services ("partial exemption").

Are your business/non-business and partial exemption methods "fit for purpose"?

There is often considerable scope for negotiating higher input tax recovery levels depending on exactly where the costs lie and how they are used. We have seen many charities saddled with poor recovery levels because either they don't understand how to obtain the maximum benefit, or they have an inappropriate method of calculation imposed on them by HMRC. For example does the receipt of legacies impact on your method? Is it correct that it should do so? HMRC will often say yes, but we usually say no!

Regular reviews are also required. If you have an agreed method that has not been properly reviewed for several years, then it may well be no longer fit for purpose. Nothing remains static in a business and tax environment and neither should your method.

Do you sell donated goods, e.g. through a charity shop?

It is well known that such sales can be zero rated; but restructuring the sale to obtain the benefit of gift aid also has a VAT implication which needs to be considered. Acting as a sales agent for the donor will lose the zero rating, and risks the outlet being treated as at least partially a non-business activity.

Legislation

Are you using every opportunity to obtain those VAT reliefs specific to charities?

Examples of these can be found below:

- Exemption for fundraising events
- Zero rating for advertising costs
- Reliefs for certain types of building work either for the charity's own use or for handicapped persons
- Exemption for health and welfare services – another difficult "borderline" issue
- Exemption for admission to cultural service events
- Zero rating for supplies of certain aids for the disabled

Key areas of your activities where you will need to be particularly VAT-aware:

Income liabilities

Property

Non-business and partial exemption

Reliefs

Conclusion

Finally, are you completely confident that you can handle an HMRC VAT inspection without mishap?

If not, you had best get some expert advice from your MHA contact. We are here to help and have experience of dealing directly with HMRC on these kinds of issues.

To discuss these issues in more detail please contact your local MHA member firm.

Legislation

5. Charity trading subsidiaries

Sudhir Singh, DChA

MHA member firm – MHA MacIntyre Hudson

As statutory funding for the sector has declined, so charities are increasingly becoming more entrepreneurial and are exploring new commercial trading activities, both charitable and non-charitable.

Certainly in our experience a number of clients from across the MHA charity client base have shown themselves to be resourceful and have found many innovative ways to bolster depleting charity funds. Throughout the planning, set up and management of these types of activities we have worked closely with them to ensure they avoid the pitfalls that regularly catch the unwary.

The commercial trading activities of charities require careful consideration if difficulties are to be avoided. Generally it is advisable to undertake these activities within the charity itself, taking advantage of exemptions available under charity and tax law. This guidance does not provide details of these wide exemptions, but they should be fully considered. Furthermore, in the short term where trading exemption limits are only just breached it may be better and more cost effective for the charity to pay some tax rather than set up a subsidiary. In many cases however it is appropriate for activities to be undertaken through a wholly owned trading subsidiary. Whilst this is a tried and trusted structure that has long been accepted by The Charity Commission or OSCR and HM Revenue and Customs (HMRC), there are some significant challenges to be overcome.

Legislation

Why have a trading subsidiary?

The basic premise for trading subsidiaries of charities is simple. The wholly owned trading subsidiary undertakes the commercial trading activities that do not fall within the objects of the charity. The subsidiary will be taxable in exactly the same way as for a normal company. However, it is possible for the subsidiary to reduce its profits so that it has no taxable profit remaining, by making payments to the parent charity under Gift Aid. As long as the charity applies the Gift Aid payment for charitable purposes and the donor subsidiary does not receive any material benefit as a result of the Gift Aid payment, this would be an effective means of sheltering any profits that would otherwise be taxable. Typically therefore trading subsidiaries will not pay dividends.

The regulatory viewpoint

Both The Charity Commission or OSCR and HMRC view the nature of the relationship between a charity and its commercial trading subsidiary as an investment activity. Indeed charities need to have appropriate powers in their constitution in order to make the investment. Therefore it is essential for charity law and tax purposes that there is an appropriate “arms-length” relationship between the two entities. For example, the subsidiary should be charged on a commercial basis for services and facilities supplied by the charity. Typically this will be done at cost and ideally under the terms of a formal cost-sharing agreement. A licencing agreement will normally be used to provide clarity over the use of charity assets and resources by the subsidiary. Other formal documentation may be helpful to determine operational matters. Adopting the mind set that this is a third party relationship will often help get things right.

Funding considerations

The profit stripping payment must be physically made by the subsidiary which will reduce the working capital it has available to fund its activities. This is often mitigated by the fact that the Gift Aid payment can be made up to 9 months after the company’s year end, for wholly owned subsidiaries.

Where there is still a need for working capital in the subsidiary, the options are normally limited. The Charity Commission or OSCR does not favour significant investment in trading subsidiaries by way of share capital as there is less security for the charity should the subsidiary’s business fail; hence the normal approach is for loan funding to be provided by the parent charity. There is a duty on trustees to only lend to the trading subsidiary at arms length (i.e. at a commercial rate of interest) and to obtain security for the loan. The trustees ought to therefore have a formal loan agreement setting out:

- A market rate of interest on the loan;
- A fixed or floating charge over the assets of the trading subsidiary if any; and
- A fixed term over which the capital will be repaid.

In addition, there should be a formal business plan supporting the commercial case for the company and the loan repayments, which typically should cover a period of at least three years and include financial projections and scenario analyses for:

- Profit and Loss accounts;
- Balance Sheets; and
- Cashflow forecasts.

Following this approach should also mean the loan will be regarded by HMRC as a qualifying loan and thereby represent appropriate charitable expenditure, otherwise this will have an adverse tax impact on the charity.

Other tax considerations

It is important to recognise that in order to finance the repayment of any loans the subsidiary will need to retain profits and a tax liability is therefore likely to be incurred. As a result of differing calculation rules the profit may not be the same for accounting and taxation purposes, and hence must also be considered.

The activities of the subsidiary may mean that it will have to register for VAT hence it is essential that its VAT status is considered as part of the company’s business plan. It is important to recognise that whether the trading is charitable or non-charitable is not normally relevant for determining its VAT status as a business activity, and charges between entities have implications for VAT, so care needs to be taken as the rules can be completely different to the corporation tax rules.

Finally, other taxes should also always be considered, often the most significant being business rates.

What legal structure to adopt?

A trading subsidiary is simply a company owned or controlled by one or more charities. However it is important that charities choose a legal structure which is most appropriate for their trading subsidiary. In virtually every case a company limited by shares will be the best option, although social enterprise structures such as Community Interest Companies may occasionally be used. Similarly in almost all cases the entire issued shares will be owned by the charity as there are issues to consider if that is not the case. This share ownership gives the charity ultimate control over the appointment and removal of the directors of the company and hence over its operation. Standard articles will normally be adopted for the company but there can be situations where particular provisions will be beneficial. As this is a complex area it is best to take professional advice.

Legislation

What records need to be kept?

As separate entries, both the charity and the subsidiary must fulfil their own statutory records obligations including accounting records and company secretarial documentation. For example all governance decisions taken need to be recorded, along with any advice received. Steps need to be taken to ensure that the two entities are clearly distinguished and meetings of the two boards need to be held separately.

Separate bank accounts will also be needed as for Gift Aid purposes there must be a clear transfer of funds.

This is more than just getting the paperwork right, as the substance of the relationship is also critical.

Subsidiary versus charity governance

The subsidiary is a separate legal entity hence must have separate governance arrangements. Governance problems, such as conflicts of interest, between the organisations should be minimised if there are sufficient independent directors on the board of the trading company. In determining the membership of the board of directors of the subsidiary it is essential that there is at least one director who is not also a trustee of the charity, and vice versa. Often this is achieved by charity executives being subsidiary directors. The optimum situation, however, would be for the trading subsidiary to include on its board a sufficient number of independent people to be able to form a quorum under the terms of the trading company's constitution – that independent quorum could then review the trading company's relationship with the charity free from any conflicts of interest.

The role and duties of trading subsidiary directors must not be taken lightly. It should be remembered that charity trustees who sit on the board of the trading company cannot be paid for that work if the charity itself is not allowed to pay them.

There may well be occasions when the board of the trading subsidiary will need to obtain independent legal and accounting advice, so subsidiary directors must not be prevented from doing this.

The relationship with the trading company needs to be regularly reviewed, as is the case with all investments of a charity.

When to end the relationship?

If the trading subsidiary becomes (or seems likely to become) insolvent, this is when the duties of the two boards can diverge and create conflict. This is because the primary duty of the charity trustees is to the objects of the charity and the protection of the charity's assets, whereas in an insolvency situation the primary duty of the directors of the trading subsidiary is to its creditors. Often there is a mistaken view that there is no problem in the charity parent providing financial guarantees for its trading subsidiary. Independent advice is likely to be necessary for both boards where there are financial difficulties.

This short article cannot address all the issues that must be considered when a trading subsidiary is used. However, as long as this is done properly it remains the most appropriate way for charities to undertake commercial non-charitable trading activities. But The Charity Commission or OSCR's cautious views concerning trading subsidiaries are well placed, as there are many examples of charities that have run into major problems and have lost considerable sums of money where proper processes have not been followed. Before entering into any such arrangement, appropriate professional advice is recommended to avoid future difficulties.

This is more than just getting the paperwork right, as the substance of the relationship is also critical.

To discuss these issues in more detail please contact your local MHA member firm.

6. Risks & trustee responsibilities

Susanna Cassey, DChA

MHA member firm – Moore & Smalley

Charity trustees, also known as governors, committee members, directors or board members, have a collective responsibility, along with their fellow trustees, for managing and administering their charity, for directing the affairs of the charity to ensure that it delivers its prescribed outcomes for the benefit of the public and for safeguarding the charity's funds and assets. This responsibility includes managing the risks inherent within all these areas.

Why does risk matter?

We all manage risk in our day to day lives and jobs and draw up contingency plans to cope in the event of things not going as we expected. These plans range from the relatively simple, and often obvious, to the highly complex. While some risks and associated contingency plans may not need much consideration or monitoring others will. There is a requirement for trustees of charities over the audit threshold to include a risk management statement in their Trustees' Annual Report and in order for trustees to make this positive statement they will need to consider risks and their management in a formal way.

SORP 2005 required a statement confirming that: 'the major risks to which the charity is exposed, as identified by the trustees, have been reviewed and systems or procedures have been established to manage those risks.'

Both the FRS102 and the FRSSE SORPs, effective from 2015, require 'a description of the principal risks and uncertainties facing the charity and its subsidiary undertakings, as identified by the charity trustees, together with a summary of their plans and strategies for managing those risks.'

The intention has always been that the risk management statement will give a reader of the accounts an understanding of how the charity handles its major risks and that the disclosure will not be 'by template' but will reflect the size and complexity of the organisation. The updated wording in the new SORPs reinforces this.

Governance

Trustee responsibilities

In order to be able to make the above disclosures and effectively manage the risks of the charity, the trustees will need a framework in place which will allow them to:

- Identify and categorise the risks facing the charity, and
- Make decisions about how to respond to these risks.

Thus helping to ensure that:

- Significant (major) risks are identified and monitored and trustees can make informed decisions relating to these risks in a timely manner,
- Opportunities available to the charity are critically assessed and only pursued if the risks can be managed
- Threats facing the charity are identified at an early stage and
- The charity is more successful through better forward and strategic planning.

The risk register

One of the tools often used by trustees to monitor risk is the risk register. This will commonly list:

- the nature of each risk
- a rating for each risk, which is derived from an assessment of the likelihood that it will occur and the predicted impact if it does occur and
- what plans are in place to monitor and mitigate against each risk.

The risk register often categorises risks as follows:

- Compliance risks
- Financial risks
- Governance risks
- Operational risks
- External risks

Significant risks are those which would have a major impact and a probable or highly probable likelihood of occurring. These significant risks will be those that are of most interest to the trustees and these will be highlighted for consideration on a more regular basis than the less significant risks.

The risk register should be a working document and so should also include risks that only exist for a short period of time.

Strategies for managing risks

Having identified the risks that the charity faces the trustees must decide on the most appropriate effective way to deal with them. The three most common strategies for dealing with risks are:

- Transferring the risk to a third party e.g. through insurance or outsourcing
- Deciding that the risk is unacceptable to the charity and therefore not engaging the activity that would give rise to the risk
- Accepting that the risk exists but putting management / mitigation steps in place to bring the level of risk down to an acceptable level.

Recovery plan

Many risks that are covered by insurance policies are 'serious events' that are often outside the control of the trustees. While they may be considered a lower risk in terms of the ongoing viability of the charity, their immediate impact on the charity could be catastrophic. As part of an effective risk management process plans should be in place which documents what to do in the case of a serious incident.

Such plans are often referred to as disaster recovery plans and they set out the steps that need to be taken to move the charity back from disaster to normal operation as quickly and smoothly as possible.

Effective recovery plans will identify the functions and individuals likely to be affected and will document the order of events needed to get those functions back up and running in the correct order. Individuals should be named in the plan and the plan should be tested by those individuals to ensure that they are aware of their roles and responsibilities.

Delegation by the trustees

While it is the responsibility of the trustees to put robust risk management procedures in place this does not mean that they will be the ones doing the work themselves, this will often be delegated to charity staff. The key point is that the trustees will review the process and results, make risk decisions in significant areas and be confident that risks are being suitably managed so that they are confident to make a statement about it in their trustees report.

To discuss these issues in more detail please contact your local MHA member firm.

7. Charity trustees and conflicts of interest

Eileen Houghton, DChA

MHA member firm – Carpenter Box

Charity trustees have responsibility for directing the affairs of a charity; they have duties of compliance, prudence and care.

Their duty of compliance requires integrity, and the avoidance of any conflicts of interest between the charity, and personal or professional interests. This includes perceived as well as actual conflicts of interest.

If trustee decision making is influenced by personal circumstances, or involvement with another organisation, there is a conflict of interest. This article aims to help trustees identify and manage conflicts of interest.

Trustees have a duty to always act in the best interests of the charity and its beneficiaries. According to law they cannot receive any benefit in their capacity as trustee unless they have express legal authority to do so.

Governance

Identifying conflicts of interest

Trustees must aim to identify conflicts of interest at an early stage and manage them appropriately.

Conflicts of interest come in many forms:

- direct financial gain – the charity awarded a contract to a business owned by the trustee
- indirect financial gain – trustee's partner is employed by the charity
- non-financial gain – trustee is a user of the charity's services
- conflict of loyalty – trustee's friend is employed by the charity

Trustees are expected to identify conflicts of interest and ensure any personal trustee benefit is authorised. Legal authority may be given where the charity is able to demonstrate it is in the charity's best interests to allow the benefit, and that the conflict is transparently managed. This authority will either be from the governing document, The Charity Commission or OSCR or the Court. If there is any doubt as to whether authority exists, trustees should seek legal advice or contact The Charity Commission or OSCR directly.

Where there is a conflict but there is no material benefit to a trustee, no authority is required but policies and procedures are required to ensure such conflicts are managed appropriately.

Failure to manage conflicts of interest may result in a breach of trust, and as such any resulting transactions or decisions may be invalidated and the trustee concerned could be liable to return the value of the benefit.

Managing conflicts of interest

Unmanaged conflicts can create problems, such as:

- invalidate decisions in the eyes of the law
- question the motives behind trustee decisions
- damage the charity's reputation
- inhibit free speaking of trustees
- adverse effect on the operation of the trustee body if they feel pressure where a fellow trustee is involved

If a trustee has a conflict of interest, they need to be transparent about this immediately and not be a part of any meetings or discussions on that subject.

It is good practice to have a written policy on dealing with conflicts. It should include guidance on procedures to follow, for example removal of said trustee from the meeting during any associated decision making, managing any ongoing conflict and minuting details of discussions and decisions.

An up to date register should also be maintained and reviewed regularly for changes. Upon appointments of new trustees they should be required to make full written disclosure of their interests. This disclosure may then be used to consider whether appointment is appropriate, as conflicts may make it difficult for them to participate fully in the running of the charity and decision making process.

The Charity Commission or OSCR website includes a link to example polices and a model interest register.

Failure to manage conflicts of interest may result in a breach of trust, and as such any resulting transactions or decisions may be invalidated and the trustee concerned could be liable to return the value of the benefit.

We would also remind directors of charitable companies that they are subject to the provisions of the Companies Act 2006 in relation to conflicts of interest.

To discuss these issues in more detail please contact your local MHA member firm.

Governance

8. Trustees and the art of delegation

Sarah Case, DChA

MHA member firm - Broomfield & Alexander

Delegation is a fact of life for charities, however, organisations don't often review their delegation processes to ensure they are fit for purpose, clear, specific and comprehensive. Undertaking an annual review of delegation is a worthwhile task and far better than finding out that people do not appreciate their responsibilities when something is amiss.

Here are some reminders of delegation good practice:

Charities are led and controlled by their board

Whether they are referred to as trustees, directors or governors, the board are there to ensure delivery of the objects, set the strategic direction and uphold the values of the organisation.

Governance

Delegation to sub-committees

The first potential tier of delegation is to sub committees. These sub committees report to the board and should have a clear remit of the extent of decision making, budgetary constraints and reporting responsibilities that they are responsible for. This group will be overseeing the activities of the organisation and is not designed to deal with the everyday nuts and bolts of the organisation.

It is important to ensure any sub committees are in line with your organisations Governing Document. This document should clearly define the delegation required; specifying what each sub committee is responsible for. Put in place a reporting mechanism and ensure that you allocate people with the right skill set to the right committee.

Once the sub committees are in place the next level of delegation needs to be implemented. Delegation of staff and volunteers is an important step that needs to be thoroughly thought through.

The board have ultimate responsibility for the organisation

They need to ensure that it is well run and that it is delivering the charitable objects for which it was set up. The board must have a clear understanding of its roles and responsibilities and should provide clear, strong leadership to the organisation.

Of course this board cannot run the organisation on a day to day basis and neither can it be involved in the minutiae of decision making. Delegation is therefore crucial, but for this to be successful it needs to involve a clear structure and terms of reference to ensure everyone involved understands their roles and individual responsibilities.

Effective delegation should include:

- **Detailed lines of authority –** usually to one senior member of staff who then cascades information through the organisation
- **Role descriptions –** ensure there is clarity and consistency in documenting responsibilities
- **Effective polices and procedures to follow –** these should be written down and contain enough detail to ensure robust control but also the scope for senior team members to effectively carry out their work and make decisions day to day
- **Details of how the sub committee will provide support -** what reporting will the sub committee expect and what levels of contact will the senior members of staff have access to
- **Details of training and development –** identifying training needs and plans to address them in the future
- **Pathways for two way communication –** regular reports to the board about the use of delegated authority
- **Performance targets –** financial targets are important but impact and delivery targets are equally as crucial to the organisation
- **Financial parameters –** clear lines of delegation for spending, recruiting, signing contracts etc.

Getting the chains of delegation and communication right and working well throughout your organisation is crucial to ensuring a well run charity that contains no surprises for trustees but also empowers and encourages the senior team to create a truly excellent organisation.

The board must have a clear understanding of its roles and responsibilities and should provide clear, strong leadership to the organisation.

9. Reserves

Helen Blundell, DChA

MHA member firm - MHA Bloomer Heaven

Reserves can be a tightrope. Charities with insufficient reserves may find it hard to attract funding because of perceived financial instability, charities with larger reserves may be penalised on the basis that they are perceived to already have sufficient funds to manage.

'Reserves' is probably also one of the most commonly misunderstood terms in the sector. Some trustees understand this to mean the money in the deposit account, others see it as the whole of the unrestricted funds.

The SORP defines reserves as 'that part of the charity's income funds that is freely available'. In other words unrestricted funds not represented by fixed assets/investments and not otherwise earmarked or designated.

The need for reserves stems from the legal principle that a charity must apply its funds for charitable purposes.

Significant reserves would begin to suggest that resources are being stockpiled and not applied for the charitable purposes for which they were received. To ignore this can raise issues around breach of trust and have tax implications.

On the other hand however, to operate with nothing in reserve might be considered to be foolish and reckless.

Governance

Charities are required to have a reserves policy and where they have substantial funds designated there is also a requirement for the trustees to explain the purpose and if they are held for the future, the likely timing of the expenditure. Designated funds should not be set up purely to reduce the stated level of reserves.

So how do the Trustees begin to determine the appropriate level of reserves? It is not and should not be a standard formulaic approach. Despite The Charity Commission or OSCR's best efforts not to create a 'norm' the phrase 'between 3 and 6 months of operational costs' is frequently used.

How you determine what is required is very much dependent on the nature of the charity, how it is structured and delivers its charitable activities and what its plans are for the future. Some of the factors you might want to consider would be:

- Contractual obligations such as monthly salary bills, lease notice periods
- Contingency for the unexpected repair bill, urgent charitable need or staff cover costs
- Planned commitments such as replacement of significant assets
- Cash flow requirements (where grants are often paid in arrears of expenditure)
- Cessation of grant funding streams – bridging funds

A reserves policy does not need to be an absolute figure but can be a range. If that range has been informed by a thought process then the policy is more easily explained. A reserves policy should evolve with the organisation and not be static.

A key aspect of reserves is how you communicate this to stakeholders and readers of the annual accounts. As a minimum you want to be covering what reserves you aim to hold and why.

If you have more than the ideal reserves range then it is important to adequately communicate how you intend to use excess funds and an indication of timescales so as to demonstrate you are applying the income as required.

If you have less then you need to address what you are doing to ensure the stability and sustainability of the organisation whilst rebuilding the necessary reserves. It is also important to demonstrate that the policy is regularly reviewed to ensure it remains appropriate.

A well crafted and thought through reserves policy can pay dividends in a number of ways:

- Facilitate development of the organisation and its activities
- Assist in strategic planning
- Provide a buffer to manage unforeseen financial difficulties
- Demonstrate good stewardship to funders

Reserves should not be the tightrope you have to walk but the balancing pole to keep you stable as you walk. A good reserves policy will let you keep your head up and focus on the goals and challenges ahead instead of requiring you to look down at your feet for every step and missing opportunities.

Reserves should be informed by a thought process, evolving with the organisation.

To discuss these issues in more detail please contact your local MHA member firm.

10. Fraud

Jandy Stevenson

MHA member firm - Henderson Loggie

What is fraud?

"In general terms, fraud can be described as intentional deception for personal gain resulting in detriment to another.

Examples of where a charity might be affected by fraud include:

- embezzlement of charity funds internally by a trustee, staff or volunteer
- embezzlement of funds in the hands of third parties, e.g. partners or service delivery providers
- fraudulent grant applications
- fraud on individual members of the public via domestic or international fundraising
- money laundering

If such circumstances are proven, it is a criminal act and may attract criminal sanctions." (OSCR)

Charity susceptibility to fraud

There are some reasons why charities might be very susceptible to fraud. These include:

- High levels of confidence in the charity sector blind people to the possibility of fraud.
- Lack of strong controls either because of limited resource or over reliance on goodwill of employees or volunteers.
- Reliance on large number of volunteers.

Governance

Research

The Fraud Advisory Panel commissioned some research into the incidence, origins and impact of fraud in the charity sector.

The full report is available on-line at www.fraudadvisorypanel.org

Some of the key statistics were:

Scale and incidence

7% of the respondents had been the victim of fraud in the previous two years.

Half of them estimated the total loss at less than £1,000

2% reported losses of more than £100,000

Fraud was more common among the larger charities **(20%)**, those with full time staff **(15%)** and those with trading subsidiaries **(20%)**. The presence of volunteer workers makes no difference to the incidence of fraud.

How it happens

Most frauds took place at Head Office **(18%)** or within the banking system **(17%)** and involve the theft of cash **(28%)** or cheques **(23%)**.

Almost half of the victims know who committed the fraud. Typically it was a paid employee acting alone.

A fifth do not know where the fraud took place and a quarter do not know how long it has been going on.

Trustees' responsibilities

Trustees' responsibilities include safeguarding the assets of the charity and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Whistle blowing to the Regulator

Matters of material significance which should be reported to the Regulator.

Governance

What does the Regulator do?

Their approach has 4 key aspects:

prevention
intelligence
intervention
improvement

Prevention

They look to trustees to ensure there are basic controls in place whatever the size of the organisation and that these are more detailed in the case of larger charities. It is essential that trustees understand the risks to which the charity is exposed and where it might be vulnerable to fraud risk and make sure that controls are designed accordingly and that proper training is given to trustees and staff.

Intelligence

A report of matters of material significance allows the Regulator to make timely intervention.

The Charity regulator also has memorandum of understanding with other regulators and public bodies so that they can store information.

The monitoring programme gathers some information which may be helpful in identifying areas of risk.

Intervention

All complaints are investigated using the regulator's published guidelines.

Improvement

Formal recommendations for improvement are made to the charity.

Conclusion

Fraud is a risk faced by all charities. If it happens the impact will be wider than simply a financial hit. There is a loss of trust amongst staff and advisers. If the public are made aware then there is an issue that there will be a reputational risk.

Charities must be alive to the possibility of fraud and consider whether controls in place are adequate for the size and complexity of the charity they manage. Trust your auditors for they will make recommendations where controls could be improved and their advice should be acted upon wherever possible.

To discuss these issues in more detail please contact your local MHA member firm.

Concluding Statement:

We hope you find the latest MHA NfP insight useful. The regulatory and compliance requirements for charities can prove a minefield and having the correct procedures in place is imperative so that the organisation is able to focus on its aims and objectives rather than on issues arising within the business.

Many of the issues raised in this report will be familiar to Finance teams, Trustees and members of the Senior Management teams in Not for Profit organisations however, with proactive action, forward planning and timely strategic advice they can be easily dealt with.

If you would like to discuss any of the issues raised in this report with your local MHA member firm please do not hesitate to contact us.

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About MHA

MHA is a UK wide association of progressive and respected accountancy and business advisory firms. Each MHA member firm offers a broad range of services including accountancy, tax and corporate finance as well as sector specialisms.

MHA member firms are characterised by their strong regional reputation for providing outstanding accountancy and business advice. With 46 Nationwide offices MHA is able to balance national access and capability with the local insight and perspective which individual member firms offer their clients.

The charity sector is a rapidly changing landscape bound by more regulatory and compliance requirements than most. Collectively MHA members are able to draw from the experience of over 1600 clients in the sector and over 25 Charity accounting diplomas. Our award winning teams of charity advisers have the experience and expertise to fully understand the complex and regulatory accounting needs of your organisation.

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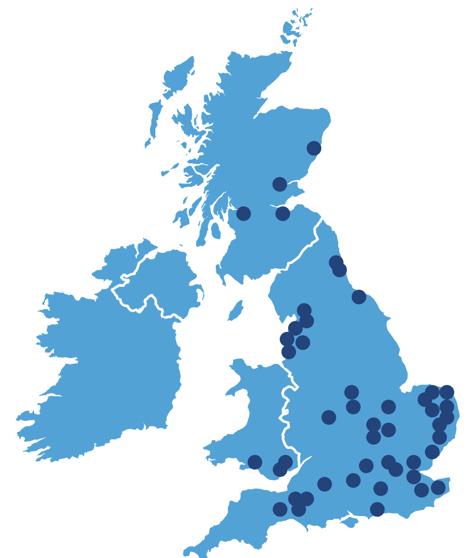

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