Price Bailey

Charities and not for profit newsletter

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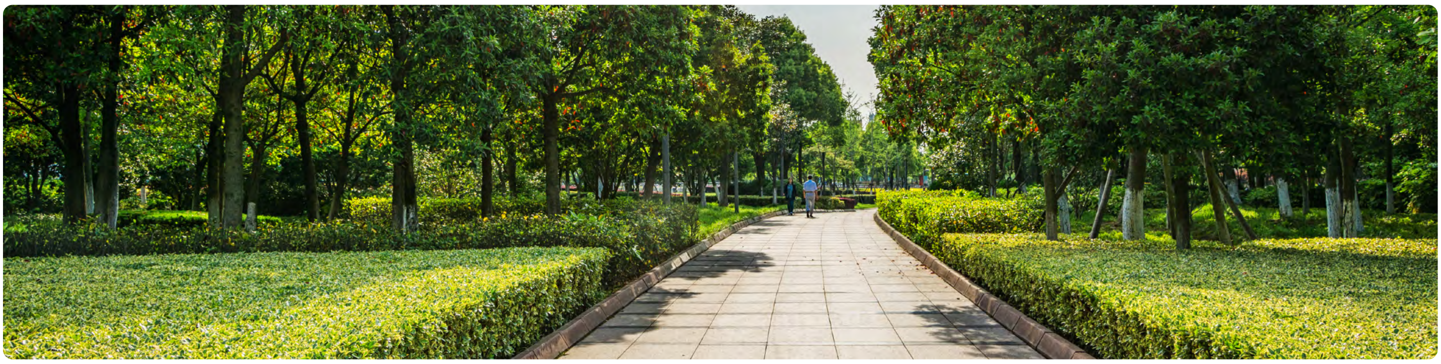
Welcome



Welcome to our summer 2021 edition of the Charity and Not for Profit Newsletter, which has continued as a blog series over the year on our website. This edition brings together recent articles published on our website into a newsletter.

It includes our article on cybercrime – the crime of our times. Over a quarter of charities surveyed by the Department for Digital, Culture, Media & Sport had been attacked in the last twelve months, and we are aware from sector media and our clients that this risk and attacks continue across the sector. This article looks at how charities should be looking at managing this risk.

Trading subsidiaries also feature with regards how the pandemic may have affected their fortunes and the need for financial support from the charity itself. This article explores the process and challenges that charities face in supporting their trading subsidiaries, advice from the Charity Commission in this regard and the steps to take to ensure that any decisions made can stand up to external scrutiny. A key aspect of the process is to clearly record and document any decisions made especially around the future viability of the trading subsidiary and its return to probability.

Another is on the updated Charity Governance code which has been updated to address comments on two of the principles which caused the most consternation in the sector. It is likely that reporting against compliance with the Charity Governance code will be mandated in the next Charity SORP so it is important that charities start to think about and plan their governance review process. In this regard, our stop press feature looks at a new Governance App just launched to help in this process.

Finally, we have a short piece on VAT recovery methods which may have been affected by the pandemic due to income changes and how to deal with this situation.

We hope you find this newsletter useful. Please do not hesitate to contact us if you need more information on anything we have raised.

Stop press:

The Governance App

The Governance App is a new free resource for the charity sector. It is managed by the Directory of Social Change and can be found here: https://thegovernanceapp.org.uk/.

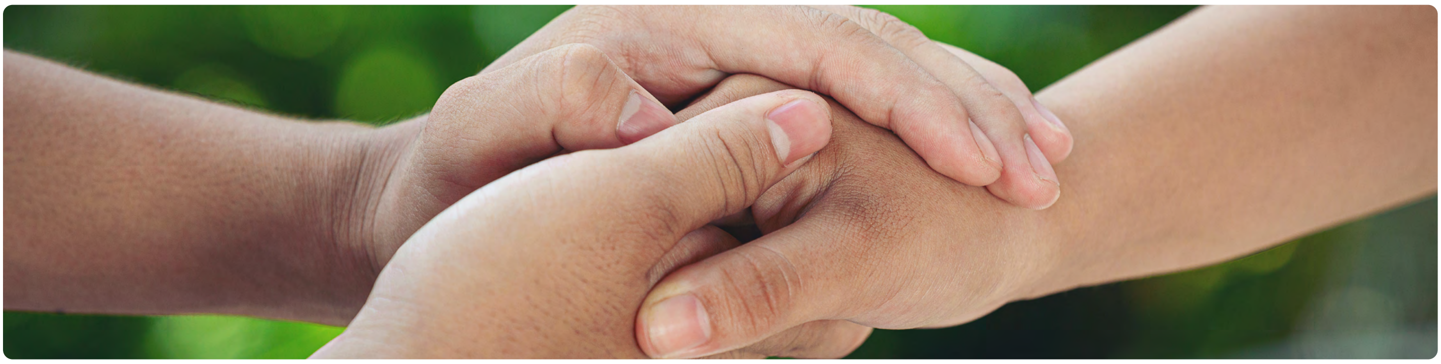
The governance app has been designed to help charities get started on their governance review journey. Charities can register for free and then engage with the whole Board to review their governance. Each board member completes the questionnaire and the app then collates the results to help form a picture of the governance of the organisation. The questionnaire consists of 70 questions and it follows the Charity Governance code.

It's a great way to get started on a governance review and to be able to form a picture of the organisation – what works well and what may need to be addressed.

Our key articles cover:

- The Charity Governance Code 2020 refresh: key changes
- COVID-19 and its effect on VAT recovery for charities
- The rise of cybercrime and how it is affecting charities
- Trading subsidiaries, the pandemic and their financial support

The Charity Governance Code 2020 refresh: key changes



The global Pandemic has significantly affected the charity sector, whereby many trustees are prioritising safeguarding cash flows and maintaining charitable activities during a lockdown, in times of increasing demand and constraints on resources. Despite economic uncertainty, effective governance and skilled trustees making informed decisions are crucial ingredients to ensure charities maximise the fulfilment of their aims and objects. The Charity Governance Code (the Code) is an important resource assisting charities to develop high standards of governance and many charities are turning to the Code to help them consider best practice and improved governance in their organisations.

The Code outlines the principles and recommendations for good governance and was created by a sector steering group. The Code is made-up of the following seven principles:

1. Organisation purpose
2. Leadership
3. Integrity
4. Decision-making, risk and control
5. Board effectiveness
6. Equality, diversity and inclusion
7. Openness and accountability

Refresh

In an ever-changing world, the Code's steering group recognise the importance of evolving the Code where required to ensure it continues to be fit for purpose.

Following feedback from an extensive consultation process, the refreshment of the Code in December 2020 focuses on enhancing Principles 3 (Integrity) and 6 (Equality, Diversity and Inclusion), which occurred as these principles received the most consistent feedback concluding amendments were required.

The Integrity principle

This principle has been updated to emphasise the importance of applying ethical principles to decision making, and ensuring a welcoming and supportive culture is embedded into the charity's values.

The rationale significantly refocuses from the primary concerns of protecting charitable assets and reputation and now additionally highlights culture, values and the right of everyone to be safe. Key outcomes now include:

- Ensuring Trustees understand their safeguarding responsibilities
- Ensuring everyone in contact with the charity is aware of how to raise concerns
- To address power imbalances/conflicts of interest where they exist or arise
- To establish appropriate procedures, which are integrated with risk management and training

Thus embedding the values, ethics and culture of the charity into everything it does and its decision making – the personal behaviour of Charity Trustees for instance is paramount which has been clarified in the Code.

The equality, diversity and inclusion (EDI) principle

The 'Diversity' principle name was renamed 'Equality, Diversity and Inclusion (EDI)' principle following consultation conclusions that the principle should be reworded to work towards inclusive cultures as well as Board diversity.

Effective EDI is considered a journey and sits at the heart of good governance. The rationale of principle 6 is to aid boards to maximise public benefit, redesign their charitable purpose where necessary and make robust and informed decisions. The EDI principle now recommends Boards to consider the following four stages of practice:

1. Assessing an understanding of EDI and considering why it is important for the charity to consider.
2. Formulate context-specific plans and targets and assess the charity's starting point.
3. Taking action and monitoring EDI performance.
4. To be transparent and learn from progress to date.

Final Considerations

The Code's principles, rationale and outcomes are considered to apply to all charities regardless of size or activities. Governance practices can differ significantly depending upon a charity's activities, complexity, income or size; different versions of the recommended practice have therefore been published to address some of these differences, split between 'larger' and 'smaller' charities.

It is worth noting that some of the principles and recommended good practices set out by the Code are deliberately aspirational, and a stretch for many charities to achieve. This is intentional, as the steering group want the Code to be a tool for continuous improvement towards the highest standards.

The full Charity Governance Code, along with additional information, can be found here.

This post was written by Simon Rowley, Manager and charity sector specialist at Price Bailey LLP.

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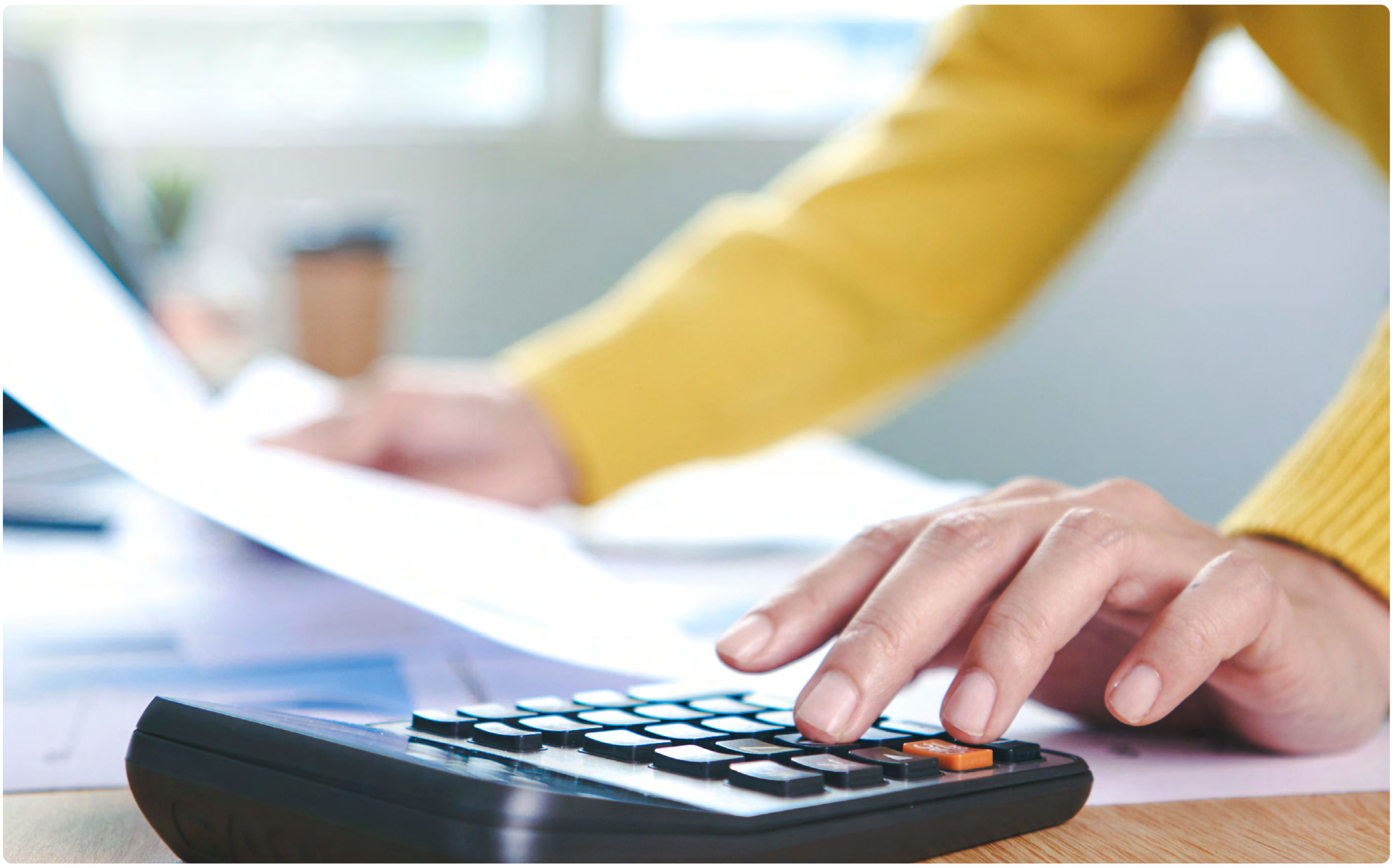
COVID-19 and its effect on VAT recovery for charities



In many cases, COVID-19 has changed not only the overall value but also the relative composition of a charity's income. Therefore, this may have implications on the charity's VAT recovery due to the partial exemption method calculations and the annual adjustment.

For VAT registered charities that need to restrict their VAT recovery based on a partial exemption method, this change could impact the amount of overhead VAT they can recover as most recovery calculations are based on income. For example, retail sales declining relative to grant income could mean more non-business and less recovery. In contrast, sponsorship, increasing relative to exempt admission income could mean a higher recovery. There will be winners and losers.

VAT recovery calculations are normally finalised at the end of your VAT year that ends in January, February or March. We recommend that you estimate the impact that COVID-19 has had upon your VAT recovery now, before undertaking this annual calculation. This is because if your recovery has been detrimentally affected, it might be possible to seek a special recovery method from HMRC. This usually will need to be applied for before the end of the current VAT year. If you predict your VAT recovery percentage will fall as a result of COVID-19, get in touch, especially if you have an open capital goods scheme item.

This article was written by Helena Wilkinson, a charity specialist and Partner at Price Bailey. If you have any questions on how your VAT recovery might be impacted, you can contact Helena using the details below.

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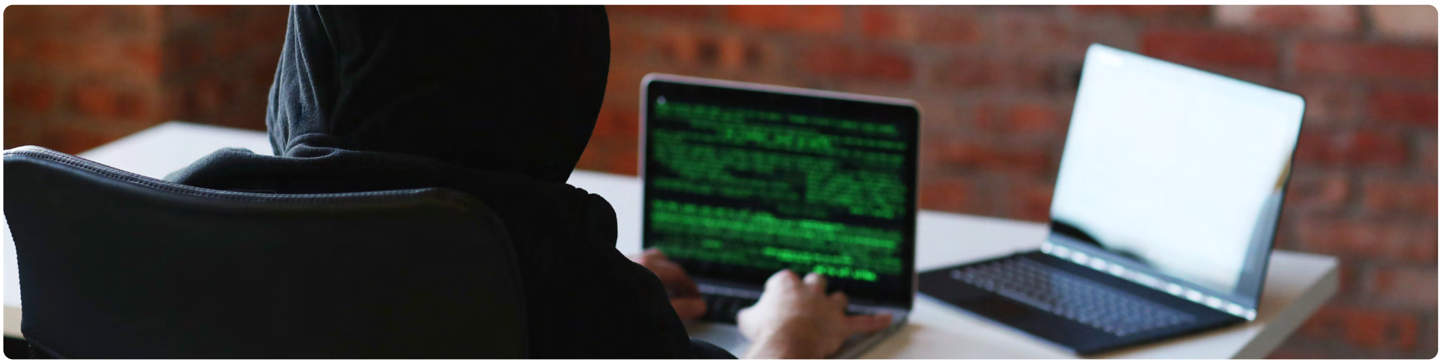
The rise of cybercrime and how it is affecting charities



Cybercrime has been around for many years but is becoming more and more prevalent in organisations, and charities haven't by any means been exempt from the issue.

The Cyber Security Breaches Survey 2021 published by the Department for Digital, Culture, Media & Sport shows that over a quarter of charities said they experienced some kind of cyber breach in the past 12 months. In particular, those charities whose income exceeds £500,000 are more at risk.

So, why are charities often specifically targeted?

Firstly, more and more charities are taking online donations and using online services. With the pandemic pushing the digital world to progress at an even faster rate than it was before, these online services are being used more and more. Therefore, unfortunately, cybercrime is also increasing hand in hand.

Remote working over the past year has also been the default for most employees, which has impacted control procedures such as signing off documentation.

Charities generally tend to place a lot of trust in the individuals they work with, be that volunteers, beneficiaries, employees, trustees. Trust is often seen to be part of the culture of working for or with a charity. This readiness to trust others can mean that charities can assume that others are worthy of trust and easily fall into the hands of fraudsters.

Some charities may also have less online security in place, maybe because of cost savings exercises, for example. It is also not uncommon for charity employees to use personal devices for work purposes, again if the charity has not been able to afford the appropriate equipment for its users.

It is probably fair to say that many charities don't have a trustee responsible for cybercrime on their board, and the issue can often be easily overlooked.

What does the Charity Commission say on the issue?

The Charity Commission hasn't issued any more guidance for charities on this specific issue; in fact, the most recent alert was back in 2018: "Watch out for CEO fraud". However, with the rise in use of the internet and remote services, propelled forwards due to the past 12 months of lockdown, it is sad to state, but no real surprise, that more and more charities are falling victim to this fraud. Amongst charities that reported breaches or attacks in the past 12 months, 18% experienced a loss of money or data, according to the Cyber Security Breaches Survey 2021.

What are the main forms of cybercrime?

There are two main types, criminal activity that targets computers and criminal activity that uses computers to target people. The most common forms of cybercrime seen currently are phishing attacks, impersonating emails and viruses.

So, what exactly is phishing? According to phishing.org, "it is a cybercrime in which a target or targets are contacted by email, telephone or text message, by someone posing as a legitimate institution to lure individuals into providing sensitive data such as personally identifiable information, banking and credit card details, and passwords. The information is then used to access important accounts and can result in identity theft and financial loss."

Criminals could send a phishing email to millions of email addresses in the hope that some people click on a link that either takes you to a fake website or triggers a virus to be installed on the victim's computer, for example. Spear-phishing a specific type of fraud where the email is targeted to a particular person, purporting to originate from a colleague.

For example, HMRC themselves are even used by scammers who pretend to impersonate a communication from the Revenue – and this has been accentuated during the coronavirus pandemic, for example, offering COVID-19 refunds or links to funding claims that are not genuine.

What can you do to protect your charity from cybercrime?

The key here is not to bury your head in the sand! Not taking action just because your charity has not been affected by cybercrime is not the answer. As is often the case, prevention is better than cure. It may be hard to see how you could be affected if you haven't yet been the victim of cybercrime, but resolving the issue could become a bigger issue once you have been.

If your charity uses online banking, social media or network-connected devices, if your beneficiaries' personal data is information held electronically, or if beneficiaries or clients can order, book, or pay online – then you ARE at risk of cybersecurity.

The key is to understand your own IT processes and procedures. What is your IT strategy? Who is the trustee responsible for overseeing this?

Firstly, you should ensure you have the correct software and procedures in place to ensure you are as protected as possible.

The second area to look at is your staff and the training they receive – is it adequate? Are all members of staff aware of the risks, and can they identify a fraudulent email if they receive one? Training to educate staff and trustees really is key to having strong defences against cybercrime. Reminding staff of the importance of strong and unique passwords is such an easy step and helps protect both the individual and the organisation.

There are many agencies out there who can help with both software and training. This dual approach of having the correct software and having a good understanding of the types of crime around and how to identify them will aid in protecting your organisation. Of course, insurance is another way to ensure you are fully covered for any eventuality.

Over the past 12 months, lockdowns have meant that organisations turn from paper records to electronic records if they haven't already. There is an unspoken assumption that emails are a safe method to deliver information. If the CEO has emailed to confirm that an invoice is ok to pay, would you trust this email as proof? Likely! But is that correct? Not always.

It is also vital to ensure that cybercrime incidents are reported within your organisation and, where necessary, to the relevant agencies.

New training package launched for charities

On 6 May this year, a new e-learning package was launched for charities and small businesses by the National Cyber Security Centre. The aim is to boost charities' ability to defend against threats posed by cybercriminals. It covers five key areas: backing up your data, protecting your charity against malware, keeping devices secure, the importance of passwords, and defending your organisation against phishing.

If you are interested, here is the link to access this free training:
https://www.ncsc.gov.uk/blog-post/training-for-small-organisations-and-charities-now-available

For many years now, we have discussed the importance of trust in charities. People want to donate to a worthy cause, and they want transparency over how the money is being used for the causes set out by the charity. It is, therefore, the charity's duty to make sure those donations count and that the charity is not being defrauded. If we all act responsibly, we can ensure charities make a difference to their beneficiaries and continue to improve the public's faith in charitable organisations.

This post was written by Alice Boesen, a Manager in the Charities team at Price Bailey. If you require any questions relating to this article, please contact Alice on the form below.

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The Charity Fraud Awareness campaign

The Charity Fraud Awareness campaign, which happens annually in October, encourages and empowers charities to talk about fraud and share best practice. It focuses on three simple messages, which are quoted below:

1. Be fraud aware:

- All organisations are at risk from fraud – being a charity is no defence
- Be vigilant – to fight fraud; you need to find fraud
- Be sure your trustees, staff and volunteers know how to spot and report fraud

2. Take time to check

- Ensure your charity has robust financial controls in place and knows how to enforce them
- Is there a counter-fraud policy that staff and volunteers are signed up to?
- Trust is exploited by fraudsters – be willing to challenge unusual activity and behaviour, whoever is involved

3. Keep your charity safe

- Prevention really is better than cure – taking simple steps now will help protect your charity from harm.
- Building a strong counter-fraud culture is vital and will boost your charity's defences.
- Help is available – seek professional advice if you need to
- Some charities may not even know they have been defrauded.

Trading subsidiaries, the pandemic and their financial support

One of the common dilemmas facing charity trustees as a result of the pandemic is how to manage their trading subsidiaries. As these subsidiaries are usually set up for tax-efficient profit generation, they may hold very little in reserves as all profits are gifted/covenanted to the charity each year within nine months of their year-end.

Profitable trading subsidiaries have usually managed their working capital and cash flow through this nine-month window after their year-end to allow them to create more profits and working capital before fully distributing their prior-year profits to their parent charity. Overall, most subsidiaries have been able to operate in this way without the need for additional loans or investment from their parent charities.

However, during the pandemic and COVID-19 restrictions, many were unable to generate profits – not able to open shops, hold events, run conferences or otherwise trade. Therefore these profitable ventures were losing money – retail grants and furlough may have helped, but some unavoidable fixed costs meant that these entities were making losses. Some are continuing to be loss-making as they still cannot trade. So what do they do? There are no reserves to fall back on as they were all given away.

Trading subsidiaries that have overall net funds can be technically insolvent. Negative funds do not necessarily mean creditors cannot be paid when they fall due as the trading subsidiary may have longer-term debt or loans, which mean it can pay its creditors.

Investment in subsidiaries through loans, working capital and share capital

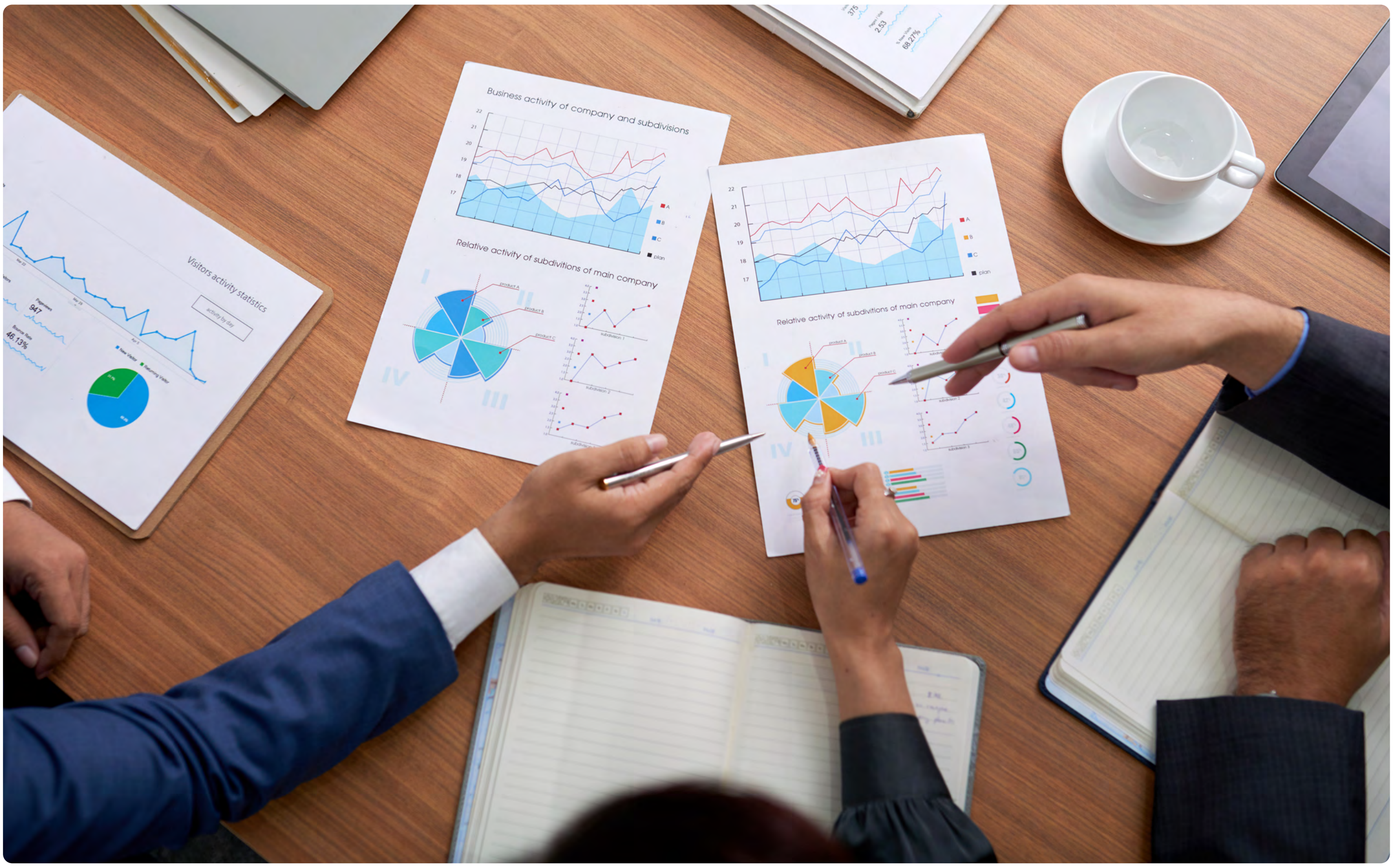
The Charity Commission updated its guidance on advice to charity Trustees in their coronavirus COVID-19 guidance for the charity sector in April 2021 and specifically picked on this issue regarding trading subsidiaries. https://www.gov.uk/guidance/coronavirus-covid-19-guidance-for-the-charity-sector#trading-subsidiaries–financial-support-from-parent-charities. This clarifies that the parent charity must consider any support and funding provided to its trading subsidiary the same as any other investment on an arm's length basis. Hence the Trustees must consider the financial return on their investment, which means assessing the financial viability of the business – its profitability, forecasts and business plans – as part of that investment decision whether the funding is provided through a loan agreement from the parent charity, investment in share capital or temporary working capital provided by an inter-company balance which operates on normal payment terms. The share capital route requires stringent review as investing in a struggling trading subsidiary in this way risks the share capital. In contrast, a loan may be able to be secured on assets and can also earn interest. In the worst-case scenario, should the trading subsidiary need to formally close, a secured loan would have a better chance of a payout, whereas a capital injection would not be last to be repaid, if at all. In normal times, and when first setting up a new trading business, such business plans and income generation projections/profitability are used by the charity to justify the ability to invest in that trading business and then reap the future rewards. At the start of the pandemic, and when lockdowns were lifted, the business plans were updated which expected a return to a viable, profitable business in a relatively short timescale and often within a year. Hence investment from charities to support these viable trading businesses meant charities did inject 'capital' into their trading subsidiaries on the basis that these funds would be returned in the near future and generate appropriate returns.

The landscape has now changed again; confidence in the economy fully opening up and allowing large scale conferences and events remains uncertain. The future of some business activities and their return to profitability is less predictable, and businesses which require international visitors and predicting their return is difficult. Even shops and hospitality that are currently open are not certain to continue as variants cause concern over the further easing of government-imposed restrictions. Will the vaccination programme prove successful against variants and allow businesses to return to a level of normality? Trustees looking at investment in trading subsidiaries face difficult decisions; furlough continuing until September may offer some assistance in their decision making by perhaps deferring discussions on the future viability of businesses until a later point. Continued investment and support of their trading subsidiaries may, on balance, still be justifiable by charity Boards for the moment. However, it may be appropriate for Boards to engage professional advice to help support their decision making at this critical time. The charity Trustees must put the interests of their charity first when looking to provide financial support and its justification as an investment. Charities cannot support and invest in failing businesses; hence it is essential that any support provided to their trading subsidiary has a clear business case and supporting documentation to evidence due diligence by the charity Board in making their decision to fund. It is equally important that the charity Board monitors the situation to ensure that the basis of any decision remains sound and that if the situation changes, appropriate action is taken immediately.

Going concern

With charities currently going through their audit process, such as with March 2021 year ends, the going concern perspective on the charity and its trading subsidiary may require attention.

As already noted, the trading subsidiary may have overall deficit funds (net liabilities). It is technically insolvent, albeit that it may have cash to pay its creditors as they fall due through the use of the working capital/loan provided by the parent charity. The charity cannot guarantee the debts of a trading subsidiary that is not delivering primary purpose charitable activity as this would be using charitable funds for non-charitable purposes.



It is commonplace instead for the charity to provide a support letter. Typically, such support letters confirm that the charity will not require repayment of any of its balances owed by the trading subsidiary for at least 12 months from the date of signing the accounts unless funds allow. Whether such a support letter is sufficient to support a going concern perspective for the trading subsidiary will require forecasts, cashflows and budgets to show that the trading subsidiary will return to profitability or the resources it has, are sufficient to survive for at least that 12-month window. If there is doubt over its future viability, then this may cause a detailed discussion with the auditors and management to consider and understand the implications on the accounts and/or audit report.

Therefore, in considering the ability for the trading subsidiary accounts to be prepared on a going concern basis, there will need to be evidence on how it will be funded and will survive – be it through further cash injections from the parent charity, a return to profitability or being mothballed until better trading conditions are available, or a combination thereof. Negative funds (or formally equity) does not necessarily mean insolvency as the company may be able to still meet its debts as they fall due but does need careful management. Depending on their circumstances, advice from insolvency practitioners may be required where that situation changes.

Conclusions

Trading subsidiaries continue to cause concerns due to the pandemic in terms of their financial support, viability and going concern status. Many now have negative funds at their latest balance sheet date, which brings a heightened responsibility on the directors over future potential insolvency and going concern issues, and future forecasts and projections may be difficult. Ensure you communicate your challenges with your professional advisers and keep them informed and take advice as the need arises. Trustees must ensure that any financial support provided to the trading subsidiary is based on sound business plans, which are closely monitored to ensure that the charity's funds are not put at risk.

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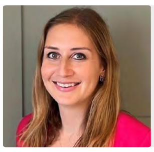

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