PULSE
Quarterly Newsletter of Deloitte's Charities and Not for Profit Group

Reza Motazedi
Partner
National Head of Charities
and Not for Profit
rmotazedi@deloitte.co.uk

The sector has been receiving very bad press recently. There are renewed discussions on governance and public accountability of charities. It takes one (reasonably) prominent charity to fail, for the whole sector to become scrutinised; sometimes by people who know little about the challenges and competition facing the sector.

Let us, however, remind ourselves that there are many registered charities in the country who have good governance in place, and keep delivering their objectives despite ever changing landscape and challenges. Let's not forget that those who have failed are in the minority.

Please note that the views expressed in this publication are those of the authors and not of Deloitte. In the complicated environment in which we all operate, always seek professional advice specifically and don't rely on contents of articles that have been written for general guidance only.

Reza Motazedi
Partner
Head of Charities and Not for Profit
Deloitte LLP

Are defined benefit schemes a benefit or a burden to your charity?

Defined benefit ("DB") pensions are a significant challenge for many charities, both in terms of size of liabilities and cash contribution requirements, but form an important part of the benefits offered to employees.

For many charities, pension liabilities can be material, creating significant, non-operational risks and substantial uncertainty.

This can be a particular issue for participants in multi-employer schemes as they also need to fund their share of the liabilities relating to members that have become insolvent. This form of pension structure is common to many charities particularly those that may have been spun out of local government control where as part of the transfer of operations existing pension arrangements were continued.

DB pension deficits have also proven to be a substantial barrier to mergers and reorganisations thereby harming the efficiency of service delivery.

Pension challenges are set against a backdrop of significant financial pressures and a difficult fundraising environment. Without robust action, pension obligations may lead to a reduction in front line services, the need to implement redundancy programmes and in some cases to insolvency.

The impact of the Living Wage and the subsequent increase on pension contributions is also going to increase pressure on charities with DB Schemes.

So what can be done? For those in significant distress due to their DB pension costs, they should be discussing options with the Pensions Regulator. In extreme cases, it may be possible to negotiate a settlement of or reduction in the pension obligations; however, this is relatively untested in this sector.

What measures can you look at to reduce the costs and volatility with DB Schemes whilst maximising the benefit for your employees?

There are a number of options that can be considered as part of a long term management plan:

- **Managing cash** – cash contributions to DB schemes need to be agreed with the scheme trustees as part of triennial valuations. As part of this process, charities should be proactively engaging with the trustees at an early stage (if in a multi-employer scheme as a group together with the other member organisations) to ensure that the actuarial assumptions are reasonable and that they evidence the charity's covenant.
  - The Pensions Regulator has expressed its willingness to allow more flexibility over how deficits are funded at the current time. Charities should ensure that they are exploring these flexibilities, including longer and increasing contribution funding plans, where required.
  - Organisations are also increasingly looking to alternatives to straight cash funding to ease cash pressures, including for multi-employer schemes. Such solutions range from bank letters of credit, company guarantees and charges over organisation assets to innovative asset backed funding structures (Deloitte pioneered this area). These structures use the assets of the organisation (for example, property or receivables) to provide immediate funding to the schemes while reducing cash outflows under a normal schedule of contributions.
- **Control costs** – If they haven't already done so, charities should think about closing their schemes to future accrual of benefits. Such moves can lead to employee relation issues, but these can usually be overcome by articulating the need for change and providing a good quality replacement defined contribution scheme.
- **Liability management** – There are a range of options to deal with legacy DB liabilities. One solution is a pension increase exchange exercise, whereby pensioners are offered a higher level of pension in return for giving up their future non-statutory pension increases. For non-pensioner members, the new pension flexibilities introduced by the Government from April 2015 can provide a strong incentive for members to transfer the value of their benefit entitlement out of the scheme. For example, members with minimal benefits can be given the option to cash these out directly. All of these options can be structured in a way to reduce deficits whilst offering an appreciated option to members.
- **Investment strategy** – this is a key consideration. The investment strategy should be reviewed regularly to ensure it is optimal (i.e. there is not another investment strategy that would be expected to generate a higher return for the same amount of risk) and is aligned with the organisation's objectives.

Defined contribution ("DC") schemes

The recent budget brought about sweeping changes for DC schemes. The key change is that, from April 2015, individuals have full flexibility around the use of their DC funds. Up to April 2015, most members were effectively forced to purchase an annuity from an insurance company. These changes have created a need to review current DC arrangements. In the case of "contract based schemes" provided through an insurance company, this obligation will fall on the organisation.

Paul Johnston
Director, Analytics and Quantitative Modelling
paujohnston@deloitte.co.uk

Phil Reynolds
Director, Restructuring Services
pxreynolds@deloitte.co.uk

In particular:

- Investment strategies: the vast majority of DC schemes invest in "lifestyle" funds that aim to match annuity pricing at retirement. The new framework will mean that these funds may no longer be appropriate.

- Communications at retirement: Members will need to understand the new framework and their options. The increased flexibility may improve the attractiveness of pensions and therefore take up. The Government is currently consulting on a new duty to provide "guidance" and charities should await the outcome of this consultation.

What are practical next steps?

DB schemes

- Understand your objectives around your DB pension schemes. How much risk is your organisation prepared to accept?

- If you are in a multi-employer scheme, engage with the other members around the pensions issue and how you will approach the trustees as a group.

- Start to plan now for the next triennial valuation of your scheme(s). Review and benchmark the actuarial assumptions. Review non-cash funding solutions. Develop a plan for engaging with the scheme trustees (as a group if in a multi-employer scheme).

- Review the investment strategy in the context of the organisation's risk budget.

- Consider liability management options.

DC schemes

For those organisations that sponsor "contract based" schemes:

- Review the current investment strategy.

- Review employee communications both before and at retirement. Await the outcome of the consultation on providing "guidance" to members of DC schemes.

- Review retirement process and options.

For those in trust based schemes, the obligation will fall on the scheme trustees but organisations may want to work together with the trustees, particularly on employee communications.

FRS 102 and the new SORP

Nikki Loan
Senior Manager,
Charities & Not for Profit
nloan@deloitte.co.uk

After years of waiting, FRS 102 and the FRS 102 SORP 2015 are finally upon us, and it is the time for all charities to start to prepare, if they have not yet begun. For many charities key changes may include additional disclosure in the trustees' report and changing format of the accounts; others may have additional liabilities once the impact of the pension changes have been analysed. Some may find the change in income recognition that is the most challenging leading to earlier recognition of legacies and other income.

This article does not cover all of the changes, but hopefully will provide some support: either that comforting feeling as you can check off each item on your mental checklist; or some points of focus as you start to develop your thinking.

Which changes most affect your charity?

Trustees' report

Activities in the Trustees' report should be structured around the activities in the financial statements. For some charities this may mean little change but for many this will require further consideration as the new SORP challenges charities to align their trustees' report, sources of income and charitable activities. Charities must ensure that they have the information available from their finance systems to report on the activities that are considered significant, rather than the information available from the trial balance driving the reporting.

Reporting must be reassessed beyond the activity focus as the new SORP challenges charities to bring balance to their trustees' reports: Clear reporting of successes and failures; how lessons have been learned; as well as how those lessons will be developed into future plans. This is not the normal mode of communication; those responsible for each charity's communications will need to consider how they manage this balance and tell their story.

Mitigating factors should be included for each of the principal risks, as well as the systems and processes that the trustees have for controlling risks. In our survey of trustees' reporting[1] we considered that 40% of charities in our sample were ready for the new SORP – with 60% still having some way to go in disclosing their risks and mitigating plans.

Other reporting to be developed include reserves reporting and disclosure of key judgements and areas of estimation uncertainty. Trustees will need to challenge management and themselves to make sure that they understand the implications of these areas for their charity and for their reporting.

Each charity must state that they are a public benefit entity and affirm that they have regard to the guidance published by the Charity Commission.

1 Surveying trustees' annual reports in the charity sector – Balancing Act

The new SORP asks that each charity not only disclose the activities undertaken for the public benefit, but further "The report should identify the difference the charity's work has made to the circumstances of its beneficiaries and, if practicable, explain any wider benefits to society as a whole." (SORP 1.20)

This challenges charities to bring public benefit to the fore in their reports and the approach will need considering in advance of the year end.

Key management personnel

New disclosures effect both the accounts and the trustees' report. The SORP requires that larger[2] charities must describe in their trustees' report their arrangements for setting the pay and remuneration of the charity's key management personnel and any benchmarks, parameters or criteria used in setting their pay. Charities will need to ensure that any reports or analyses that they are likely to rely on in making this analysis have been commissioned or are in place in advance of the year end. In addition to this reporting in the trustees' report, the total payments made to key management personnel must be disclosed in aggregate as well as the £10,000 bandings for those paid over £60,000 that are already disclosed.

Financial statement presentation

As we have already touched upon, the financial statement presentation has become more activity focused. Governance costs will no longer be separately disclosed on the face of the SOFA and investment management costs can be disclosed in the notes. Gains and losses on investment activities will be seen more prominently in the SOFA. Comparatives will be required for all fund balances, although these can be disclosed in the notes. A cash flow statement will be required for all charities, although the consultation which closed in September 2015 did pose the question as to whether there should be an exemption for those charities below the larger charity threshold. The final outcome of the consultation is awaited.

Income recognition

One of the most significant changes of FRS 102 is that income recognition criteria will move from "virtually certain" to "probable". This may mean that some donated income is recognised at an earlier point in time where there is documentation of the promise that makes receipt more likely than not. If the impact of the change in accounting policy is material, in the year of transition to FRS 102, this adjustment may lead to some income not previously recognised in prior periods being recognised directly in reserves. The area most likely to be affected is that of legacies and the SORP offers further guidance on the point of recognition and the possibility of using a portfolio approach. Where this is likely to affect your charity, the impact will need to be calculated for both years, under both basis. It is important that each charity is prepared to collect and collate this information to make the assessment of whether the change is material.

Defined benefit pension schemes

Where a multi-employer scheme is a group scheme, the previous exemption in FRS 17 from recognition of pension assets and liabilities in individual financial statements where attribution to individual entities was not possible, has been removed.

Where a charity is part of a defined benefit multi-employer plan that is not a group scheme, and it is not possible to attribute the scheme's assets and liabilities between the employers, charities can continue to account for the scheme as a defined contribution scheme. However, the charity will need to recognise any liability (including discounting if material) to make payments to fund any deficit relating to past service benefits where it has entered into an agreement to make those payments. For a group scheme, FRS 102 requires group companies to recognise their own share of scheme assets and liabilities – in practice this means including all of the surplus or deficit in the sponsoring employer's own balance sheet unless an alternative agreement can be reached. Actuarial advice may be required to assess the liabilities.

Volunteers

Under the FRS 102 SORP, a charity must include a description of the role played by general volunteers and provide an indication of the nature of their contribution in the notes to the accounts. This is in addition to the disclosure required in the trustees' report which was required in SORP 2005 and is also required in the FRS 102 SORP. Neither SORP requires volunteers' costs to be included in the accounts. Charities will need to consider how they track their volunteers, whether by number, hours provided or other method. It may be that even within a single charity different volunteers are tracked in a different manner for different activities. There should be an adequate audit trail for any disclosure.

Leases

The '90% test' for finance leases has been replaced by 8 indicators and it is possible that this will require some reclassification of leases. Charities therefore may need to reassess their leases and ensure that the classification remains appropriate. In addition, the operating lease disclosure has changed to reflect the IFRS style and the minimum value of the future lease payments should be disclosed.

2 Currently those charities with an income of over £500,000.

Other changes and transitional reliefs

There are a number of other changes, including, for example, consideration of holiday accrual accounting, financial instruments, donated goods and services, social investments and accounting of charity combinations. There are also a number of transitional reliefs available, for example previous business combinations need not be restated, and there is a one-off opportunity for charities to consider their fixed asset balances on transition:

- An item of property, plant or equipment may be revalued to fair value on the date of transition, and that fair value may be used as 'deemed cost' at that date;
- A previous UK GAAP revaluation may be used a 'deemed cost' at the date of transition; and
- FRS 102 requires the cost of a fixed asset to include an estimate of the costs of dismantling and removing the item and restoring the site. A first time adopter may elect to measure any such estimate as at the date of transition rather than on the date when the obligation arose

Project planning – the next steps

Charities should consider the impact of FRS 102 and the new SORP on their accounts and develop a project plan. The plan can be staggered, with work on the format of the accounts, restatement of prior year figures, re-calculation of the support cost allocations and allocation of governance costs, identification of prior year adjustments considered separately. This is not just a finance issue – communications, senior personnel and the trustees should all be involved in making the decisions that will affect the look, feel and impact that the charity can make through its next trustees' report and financial statements.

What do you need to know about CIOs?

Mark Harvey
Consultant, Charities and Not for Profit Team
Charles Russell Speechlys LLP
mark.harvey@crsblaw.com

The Charitable Incorporated Organisation ("CIO") is a relatively new form of legal entity specifically designed for not for profit organisations in the UK.

The statutory framework for this form of incorporated organisation was created by the Charities Act 2006; the necessary Regulations to bring those provisions into operation were only approved by Parliament at the end of 2012.

The CIO allows charities to become incorporated charities, and so able to enter into contracts in their own right.

What is a charitable incorporated organisation?

The CIO is like a company limited by guarantee (the form of organisation hitherto most frequently used by charities) in that it affords the protection of limited liability to its members and directors. It is a legal entity in its own right separate from its members and directors, but is differentiated from them in requiring only to be registered with the Charity Commission, and not also with Companies House.

There are two models for a CIO:

A foundation model where the voting members and charity trustees are one and the same (known as "closed membership") .This model is ideal if the CIO is to be run by a small group of individuals (the charity trustees) who are to be responsible for making the key decisions;

The other model is an Association CIO with a wider membership who are not all trustees (known as "open membership") who may have some voting rights at general meetings.

Advantages

The main intended benefits of the entity are that it has a legal personality, the ability to conduct business in its own name and limited liability so that its members and trustees will not have to contribute in the event of financial loss. In contrast to a limited company it only has to be registered at the Charity Commission.

The dual filing obligation in relation to Annual Returns and Accounts is therefore avoided; all and any documents that need to be filed have only to be filed with the Charity Commission.

Unlike a company limited by guarantee the CIO structure can be used only by an organisation which is legally charitable in its entirety. An application for registration takes it straight to charitable status which then has all the limitations of a registered charity and regulation and control by the Charity Commission.

The CIO can have vested in it any permanent endowment held by an unincorporated charity and this can be done by a simple vesting declaration.

Disadvantages

There are, however, some important disadvantages to be borne in mind.

An exempt charity cannot be or become a CIO, because all CIOs must register with the Charity Commission. Further, a charity with an annual income of less that £5,000 does not have to register with the Charity Commission at all, but every CIO, irrespective of its income must register.

Unlike Companies House, the Charity Commission does not operate a searchable register of charges. Although a CIO can register a mortgage on land at the Land Registry, there will be no register of any debentures issued by CIOs. Banks often require such forms of security for lending to limited liability organisations, and in the absence of a register of such charges for CIOs, it remains to be seen whether they will be willing to make advances to a CIO.

At the moment there is no facility to convert a company limited by guarantee to a CIO. The provisions that will provide a mechanism for this are not currently in force. Separate regulations to provide for such conversions need to be approved by Parliament.

Comment

This can be a useful vehicle for certain types of charity organisations and we are starting to see an increase in the number of CIOs being registered.

If an existing charity is essentially a grant making charity, making grants from the income derived from its endowments, there is unlikely to be any major advantage in becoming a CIO.

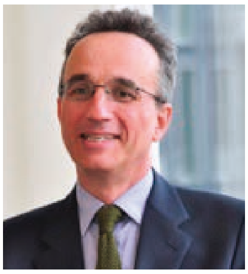
If any existing unincorporated charity is, however, providing services to the community – such as a school, or care home – then the CIO would be an advantageous way of securing limited liability for the charity trustees.

If the service providing charity is likely to need to issue debentures over its fixed and floating assets as a condition of receiving bank finance to fund its operations, the lack of any register for such instruments is likely to make the proposition unattractive to such a lender.

We now await parliamentary approval of separate regulations for the conversion of charitable companies limited by guarantee into CIOs. The government has already delayed introducing these regulations and as of yet there is no timescale for this action – further update to follow.

Economic update

In this article we look at some of the worldwide economic trends that may affect charities, either directly through demand for their services or impact on their investments, or indirectly by affecting the environment in which they operate.



Ian Stewart
Deloitte Chief Economist
istewart@deloitte.co.uk

Measuring migration

The crises in Syria and Libya have created large movements of people. Since the mid-nineteenth century international migration has been a constant theme in political, economic and social discourse.

Between 1850 and the beginning of the Second World War the largest flow of international migrants was from Europe to the Americas, as people travelled in search of a better life and opportunity. The reasons behind migration are no different as some were fleeing persecution and conflict while most hoped to find better work in a new country.

Globalisation, the declining cost of air travel and cheap communication have led to a surge in migration over the last quarter of a century. Since 1990, levels of international migration have risen by 50%. These population movements have three features:

1) While many think that immigration is largely into developed nations, 42% of the world's international migrants live in the developing world;

2) The global rate of migration has stayed roughly the same since the nineties. In 2013, international migrants comprised about 3.2% of the global population, a marginal rise from 2.9% in 1990;

3) The poorest countries are not the principal source of immigrants into rich, developed economies. Instead, it is fast-growing, transition economies such as India, China and Mexico, with educated and mobile populations that are the biggest sources of immigrants into the West. The demand for skilled labour in the West has led to a 73% rise in the number of migrants with higher education entering OECD economies in the noughties.

Trends in immigration change over time. Immigration into the UK accelerated sharply after 1997 as a result of two policy decisions by the new Labour Government:

1) Easing immigration controls;

2) Deciding not to impose transitional controls on migrants from the new EU member states of central and eastern Europe. This contributed to a four-fold increase in net migration to the UK between 1996 and 2010. In the last ten years net migration to the UK has averaged around 250,000 each year.

Migrants come to the UK largely for work and study, although there has been a recent fall in the number of overseas students entering the UK.

Germany has the largest migrant inflows in the EU, followed by the UK. However, foreign nationals make up a higher proportion of populations in smaller member states including Luxembourg, Cyprus, Latvia, Estonia and Austria.

Differences in demographics, incomes, opportunity and stability continue to offer powerful reasons for people to seek a better life overseas. The big difference today is that cheap travel, porous national borders and rising incomes in emerging economies have significantly increased the proportion of the world's population that is able to travel.

China weakness = lower interest rates for longer

America's Federal Reserve has recently announced that it was maintaining interest rates at their historic low levels. For several months the Feds have been hinting ideas to raise interest rates this year.

Rates staying on hold indicates growing concern among policymakers about the effects on America's recovery of the slowdown in emerging economies, especially China, and recent equity market weakness.

Markets took the decision as official confirmation that US growth is vulnerable to China's slowdown. Equities sold off after the announcement, with the UK FTSE 100 dropping 1.4% and the US Dow down 1.7% on Friday trading.

Having taken great pains to nurture a recovery, policymakers are wary of jeopardising it with premature interest rate rises. The Fed needs to be confident that the first rate rise will be the first of many. Above all, it wants to avoid damage to the economy, and to its reputation, by raising and then having to cut interest rates.

Low inflation provides another reason for the Fed's caution about raising interest rates. US prices rose by just 0.2% on a year ago, with big falls in the price of energy and food helping drag the inflation rate down. The same story holds in the UK and the euro area, with inflation running at 0.0% and 0.1% respectively. With inflation out for the count, central banks can afford to take their time before raising rates.

Crucially, while low commodity prices are a problem for producing nations like Saudi Arabia, Russia and Brazil, they are a boon for commodity consuming countries. Over the last year falling food, fuel and transport costs have boosted consumer spending power and activity in the West.

The decision to keep rates on hold in the US illustrates a wider dilemma for central banks. The world may have emerged from recession, but inflation is flat on its back and the risks to Western growth from emerging market weakness have risen. Until there is greater confidence that growth can be sustained central banks are likely to keep interest rates at rock bottom levels. It now looks quite possible that US and UK interest rate will stay at current levels until well into 2016.

German reunification and the triumph of politics

This month marks the 25th anniversary of the reunification of Germany. Integrating two vastly different economies was a hugely risky venture. West Germany was a global powerhouse while East Germany was an economic weakling, wracked by poor productivity and unprepared for the introduction of a market system.

One of the main decisions facing West German politicians was the choice of official exchange rate between the West German Deutschmark (DM) and the East German Ost-Mark. The DM was one of the world's strongest currencies and the Ost-Mark was the currency of a feeble economy so the market reached its own verdict and in the winter of 1989-90 the Ost-Mark was trading at seven to one DM.

This exchange rate destroyed East Germans' spending power in Western shops and set up huge incentives for the citizens of East Germany to seek work in the West. With the opening of the border, tens of thousands migrated westwards. The shift in population undermined East Germany's economy and placed huge pressure on West Germany's welfare system.

This set the scene for an epic battle between politicians and policymakers over the choice of an official exchange rate for the Ost-Mark.

The policymakers, West Germany's Bundesbank, wanted the Ost-Mark to trade close to a market exchange rate and argued that a weak Ost-Mark would help offset the effects of poor productivity and would help East German industry cope with reunification. The Bundesbank warned that an artificially high exchange rate would force up costs in the East and inflict more damage on its economy.

West Germany's Chancellor, Helmut Kohl, disagreed. He wanted a one to one exchange rate, believing it would provide stability, preserve the spending power of East Germans and stem the flow of migrants. A one to one exchange rate would also go down well with the new citizens of the Federal Republic. As a result, in the summer of 1990 the DM was introduced in East Germany.

On the economics, the Bundesbank was proved right. A one to one exchange rate added to the woes of a chronically weak economy struggling with foreign competition and the introduction of markets. Many East German businesses went bankrupt, unable to afford a dramatic rise in wage and pension costs. By the mid-90s East German industrial output had fallen by almost 30% from 1988 levels.

The choice of exchange rate made it harder for East Germany's economy to catch up with the West. 25 years later, unemployment in the East is twice as high as elsewhere. And the eastern states are considerably poorer – a West German is twice as likely to drive a BMW while an East German is twice as likely to drive a Skoda.

Yet the decision on the exchange rate was about politics, not economics, and in these terms it was a success. Reunification has worked. Today the two Germanys are a single nation and the dominant economic and political power in Europe. A generous exchange rate avoided the destruction of the spending power and savings of East Germans and made them feel equal citizens in the newly united Germany.

If you would like to hear more on the current economic climate our regular Monday briefings can be found at https://www.deloitte.co.uk/aem/monday-briefing.cfm

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