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It is with pleasure that I write this introduction; the wheels of change have been put in motion. The economy is recovering and as the recovery gathers pace, charities will find themselves in a positive environment. The feel good factor is coming back and it will, undoubtedly, spill over to the sector, hopefully bringing back much needed public donations.

We have a packed edition with articles on social investment, on principles of investment aspirations and updates on tax and SORP. As usual, there is an update on legal matters provided by Charles Russell.

Enjoy reading!

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

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Social Investment: comment

In 2013 I was appointed as a Clore Social Fellow, sponsored by Deloitte. With an interest in how social change is financed, I have spent much of my Fellowship working with both social investors and recipients of social investment, and have been able to engage in debates around social investment in the UK and internationally. This article focuses on some key issues around social investment which I believe warrant further discussion and consideration: investing in the pioneers, the financing needs of social ventures and the importance of non-financial support.

Social Investment

Social investment in its simplest form is investment which achieves a combination of social and financial return. Within this definition there can be a large number of variations which has the potential to make every social investment unique, for example the type of social investment (e.g. loan, social impact bond), the balance of social versus financial return, and the types of organisations financed which can range from traditional charities through to commercial businesses with a social impact.

Social investment can offer a win-win situation for both an investor seeking to make a financial return but who is also interested in supporting social impact, as well as the social venture which is delivering social impact and needs investment to grow and develop.

The social investment market in the UK has grown considerably over recent years, with latest information indicating annual investment of over £200 million. The UK government has also made significant efforts to promote social investment market, launching Big Society Capital with £600 million of funds, establishing investment readiness programmes, and introducing a social investment tax relief in 2014.

Investing in the Pioneers

Social investment often involves a trade-off between financial and social return. Social ventures which have the potential to provide high levels of financial return and a high social impact are few and far between. Observers of the UK social investment market have commented that this has resulted in social investors swarming over a small number of social investment deals, sometimes at the expense of considering the less financially lucrative deals but which offer good social returns.

This trade-off between financial and social return becomes more pronounced when investing in social ventures targeting the poorest in society. For social ventures operating in environments where there may be no viable markets, financial returns aren't always a realistic prospect. Yet these ventures may have the potential to make significant social returns, perhaps on a transformational scale.

A recent article from Stanford Social Innovation Review, Closing the Pioneer Gap, highlights this issue:

'One of the most striking findings of our research is that few investors are willing to invest in companies targeting the poor, and even fewer are willing to invest at the early stages of the creation of those businesses, a problem we call the Pioneer Gap ...... Our research uncovered that although there are certainly many businesses with positive social impact and promising financial prospects, businesses that directly serve the poor nearly always operate in environments that make outsize financial returns extremely unlikely.'

There appears to be a gap in social investors' willingness to compromise on financial returns in these situations, putting up genuine risk capital for pioneering social ventures.

A recent report by the Association of Charitable Foundations on charitable trusts and foundations' engagement in the social investment market highlighted that charitable foundations can play an important role in addressing this gap. The research found that many foundations engaged in social investment justified high risk taking and lower expectations of financial return on the basis of the social return generated which contributed to their charitable objectives.

But I don't think we can rely just on foundations to provide the risky capital that pioneering social ventures targeting the poor need. Foundations also have other demands on their resources which means that making financial return on some of their investments is necessary. Other investors are needed to provide risk capital to support early stage social ventures which have the potential to bring about transformational levels of social change.

Investment needs of social ventures

Social Enterprise UK's State of Social Enterprise Survey 2013 found that access to financing remained the most common barrier to the growth and sustainability of social enterprises in the UK. The survey found that the median amount of finance sought by social enterprises was £58,000 – below the minimum thresholds of many specialist social investors and financiers. This issue is also reflected in the social investment space internationally where most social ventures are looking for seed capital in the range of $50-100,000.

'It can be argued that some specialist financing structures have fallen out of step with the actual needs of the sector.'

Social investment can have high transaction costs. Identifying suitable investment opportunities, carrying out due-diligence and structuring deals is resource intensive. In order to make their own businesses financially viable many social investors have a minimum level of investment way above what most social ventures actually need.

The importance of non-financial support

Alongside financial investment in social ventures, non-financial support has proven to be just as valuable. Many social ventures looking to take on financial investment need support to become 'investment ready'. Beyond this support in the form of mentoring, skills development and sector contacts can strengthen a social venture's capacity at all stages of its development. Deloitte's Social Pioneers Programmes along with organisations like UnLtd offer valuable non-financial support in recognition of these needs, and many social investors now offer a package of support consisting of both financial and non-financial resources.

The last word

There are many different rationales and approaches to social investment, some of which may have more of a focus on financial return and others which emphasise social return. I think there is a place for all of these in meeting the needs of different types of social ventures.

If social investors are explicit about their particular interests and approaches, together with social ventures being clear about their needs, financial and otherwise, then there is a greater chance of the social investment being successful and a win-win outcome for both parties.

In the current market where there are increasing numbers of social investors, social ventures seeking financing can choose which social investor is most closely aligned with their needs. Being clear about the stage the organisation is at, what financial return the organisation can reasonably re-pay, and non-financial support needs can really help social ventures to identify the most relevant social investment financing options. And often social ventures looking for finance have more bargaining power than they realise, and can use this to negotiate terms which more closely meet their needs.

Social investment has great potential to be a vehicle for collaboration and engagement between financiers and social ventures. But further debates are needed to draw out some of these issues to ensure that social investment achieves genuinely mutual gains.

Squaring the Circle: How to reconcile a charity's principles with its investment aspirations

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Financial investment is a complex business. It is arguably even more complex for charities. Charity trustees must reconcile the needs of their mission with the need to generate sustainable financial returns that will enable them to pursue that mission for the long-term. The need to make a financial return must also be reconciled with the need to maintain a spotless reputation in a world where charities are often expected by their supporters to behave as moral guardians of society, whatever the supporters' own, perhaps more flexible, moral views.

An ethical approach

Charities have often tried to square this circle by adopting an ethical approach to investment. Ethical investment has a long history that dates back to Charles Wesley and his Methodist movement, and it is an approach that is still practised commonly by religious groups. However, it is not simply about religion. An ethical approach can also work for investors with clear moral views and, as a result, it has often been favoured by charity trustees. Not investing in companies and industries that contravene a shared set of moral views may sound easy in theory, but in practice it can often prove difficult.

Traditional ethically screened funds prohibit investment in companies and industries that a charity with a specific mission wishes to avoid, but will also exclude some to which the charity may have no moral objection. A cancer charity, for example, may want to exclude tobacco and tobacco-related products, and a temperance charity may not want to buy brewers, but both may be happy to invest in nuclear energy as a form of lower-carbon power generation that can help limit the impacts of climate change as well as deliver long-term, sustainable and affordable power.

Every sector and industry may have ethical pitfalls, and ethically screened funds are not like pick-and-mix sweets; one cannot select only the ethical flavours one likes. As illustrated by the example above, an ethical screen may cast its net wider than a charity's intended exclusions. Furthermore, beyond a certain threshold, the exclusion of companies for ethical reasons – and some estimates suggest that up to half of all companies in the FTSE100 index could be excluded on ethical grounds –may limit investment opportunities, reduce diversification benefits and cause adverse portfolio performance.

A charity can, of course, choose a segregated mandate with specific, bespoke exclusions. But bespoke exclusions are no more straightforward to manage than standard exclusions, and they create another challenge: cost. Bespoke mandates are expensive, and the higher the fees paid to an investment manager to create, monitor and run bespoke exclusions, the higher the risk that a charity will not generate the required financial return it needs to support its core charitable aims.

While ethical screening offers charities a solution, it can be costly and complex, and it is not failsafe. Furthermore, it is not always the obvious 'sin stocks' that can cause a charity financial and reputational damage. One of the most spectacular and early failures of the financial crisis in the UK was Northern Rock, a company whose simple business model was perceived by many investors as low-risk, given its focus on the UK mortgage market, and as socially useful in broadening access to home ownership. Similarly, before April 2010, BP was perceived as an international oil company that operated safely and with integrity in its upstream business, as well as one making the transition to a lower-carbon, greener business model. Five years on from the Deepwater Horizon Gulf of Mexico spill, BP remains tarred with the legacy of that disaster. More recently, following garment factory fires in Bangladesh, the real cost of cheap clothing has become very apparent to customers and investors. Many clothing companies that used these suppliers would have passed ethical screens, and clothing retail has generally been seen, from an ethical standpoint, as a relatively low-risk business.

The fact is that no one knows today what industries may be morally or ethically acceptable tomorrow, and no one knows with certainty which investments will produce a financial return in 20 or 30 years.

The alternative

If there are no easy moral or financial answers, and exclusion is more complex than it first seems, what alternative approaches exist? Can charity trustees find a solution that will allow them to harmonise the seemingly irreconcilable imperatives of reasonable risk-adjusted financial return and principled investment beliefs?

Responsible investment offers just such an alternative approach. It can complement ethical screening and help reconcile the need to generate long-term financial returns with environmental, social, and governance (ESG) concerns. A responsible investment approach enables investors to consider a broader range of issues than those included in traditional financial analysis. In considering ESG factors as an integral part of the investment process, responsible investment offers a more holistic view of company valuation or, to put it another way, it takes a 'bigger picture'.

Responsible investment and ESG integration can be used in both passive and active investment approaches. In the former, a manager might track an index such as the FTSE4Good or the Dow Jones Sustainability™ Indices. An active manager will seek to beat market returns through active stock selection. As an active manager with a long-standing commitment to ESG integration within its investment process, Newton believes that responsibly managed companies are better placed to achieve sustainable competitive advantage and long-term growth.

ESG issues range from traditional corporate governance matters of board composition, pay and ownership to the sustainability of social and environmental issues, including human rights, labour standards, carbon emissions and water use. Responsible investment considers ESG issues to be financially material because poor ESG management (or ESG mismanagement) can lead to operational, business and financial risk. A company that manages its environmental impacts so badly that it causes massive spillage or wide-scale pollution is very likely to suffer financial loss both through fines and lawsuits, and its investors would suffer from a consequent falling share price. The board and senior management teams would probably have to spend valuable time solving past problems instead of setting the company up for future growth. The company's intangible value is also likely to take a hit: brand reputation, once lost, is tough to earn back, which can have implications for attracting and retaining talented employees.

Responsible Investment

A responsible investment approach is not, however, just about good risk management, or predicting and avoiding the next company disaster. It is a positive approach to investment that recognises the links between ESG factors and company performance. It acknowledges that companies that are managed responsibly and sustainably in the interests of all stakeholders are likely to do better, retain loyal employees and satisfied customers, avoid scandals, and create long-term value for their shareholders. That is why we contend that responsible investment is, simply, better investment.

The introduction of Social Investment Tax Relief – will it have the intended impact?

The provision of incentives to encourage investment in social enterprise demonstrates the Government's belief that key social problems can be tackled and delivered through alternative sustainable channels. Some may consider this to be an essential shift in approach for the Government to alleviate mounting pressures on public funds.

Grow the social investment market

Investment in social enterprise forms part of Government's initiative to 'Grow the Social Investment Market'. In 2013 the Government made a commitment to introduce a tax relief for qualifying investments in social enterprises, defined as community interest companies, community benefit societies or charities (the Treasury has the power to extended the list to other organisations, but has not done so to date).

As part of the formal consultation on Social Investment Tax Relief ('SITR') in 2013 social enterprises highlighted the difficulties they encountered when trying to access funding. The Government hopes that SITR will diversify the social enterprise investor base, bring essential capital to the sector and enable significant expansion of social enterprise.

Social investment tax relief

In the Budget 2014 it was announced that from 6 April 2014 until 5 April 2019 (or later, if the Treasury decides to extend the relief), SITR will be available to individuals who make equity investment or certain loans to qualifying organisations with a maximum of 500 employees.
As set out above, qualifying organisations must be:-

- Charities;
- Community Investment Companies; or
- Community Benefit Companies (Bencoms); or
- any other body prescribed, or of a description prescribed, by an order made by the Treasury;

and they must carry on a trade on a commercial basis.

A qualifying social enterprise will be entitled to investments up to EUR 344,827 over 3 years (c. £290k); meaning a maximum of EUR 200k tax relief over 3 years.

An individual making qualifying investments will receive:

- Income tax relief at 30% – on investments up to £1m per annum.
- Exemption for chargeable gains tax on disposal of a qualifying investment.
- Deferral of chargeable gains tax on disposal of other asset – up to the value invested in the social enterprise – until the social investment is disposed of, or the conditions of the investment cease to be met.

The final legislation will be included as part of the Finance (No.2) Bill 2014.

The rate of tax relief is the same as the rate of relief available under the Enterprise Investment Scheme (EIS), so makes investment in social enterprise equally as attractive as investing in small business.

Concerns

The Roadmap for Social Investment, published at the end of January 2014, included timings for addressing concerns that were identified as part of the formal consultation process for SITR. A particular concern related to the maximum level of investment available of c. £290k over 3 years, due to the European Commission state aid rules. It is understood that the process to seek approval from the European Commission to extend the level of qualifying investment has now commenced. This process is expected to take 18 months. In the meantime the impact of SITR will initially be limited.

Key concerns regarding the drafted legislation related to the complexity of the operation of the relief.
A draft guidance document was published by the Government at the beginning of April, which outlines the eligibility criteria for both investors and social enterprises, including worked examples, as well as compliance requirements. However, it is anticipated that many social enterprises may not have sufficient internal capability and resource to interpret the rules and appropriately monitor the relief criteria – in particular in relation to organisation expansion and growth. This may create an additional cost associated with raising funds, hence create a barrier for smaller enterprises, which ultimately may not be able to benefit. Simplification of the criteria would be one way to minimise the costs of obtaining finance through the scheme.

Impact on charitable giving

The 30% rate of income tax relief is higher than the 25% rate of relief available to higher rate tax payers (40%) through the existing gift aid scheme. It will be interesting to understand whether the 30% rate of relief impacts wider charitable giving behaviours, for example if gift aid donations are diverted into investment in social enterprise.

The recently published Public Accounts Committee report on Gift Aid stated that data had not been collected to evaluate whether Gift Aid relief was working as intended. The report recommended that the impact of Gift Aid on donor behaviour should be better understood. It is possible, therefore, that the impact of SITR may be subject to a more detailed level of scrutiny.

Big Society Capital research suggests that SITR could create up to £500 million of extra investment into social enterprise over the next five years. A greater level of scrutiny should make it possible to evaluate the impact of SITR and to assess whether it aligns with original set out intentions.

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What you need to know about industrial and provident societies?

Many charities regularly interact with other charities, whether to make or receive grants or services, share best practice, emulate successes or avoid pitfalls. When doing so, it can be important to have a basic understanding of the legal nature of that other charity. While the natures of unincorporated charitable trusts and of charitable companies are widely known, Industrial and Provident Societies are frequently unfamiliar territory for those in the sector. The law in relation to them is changing this year, and so now is an opportune time for an overview of their key features.

Industrial and provident societies

An Industrial and Provident Society (a "Society" in this article) is an incorporated body, like a company or a CIO, but registered with the Financial Conduct Authority (the "FCA"). It has a separate legal identity and so can hold property in its own name and enter into contracts. There are over 7,600 Societies in the UK, split into two types: co-operatives and community benefit societies.

Co-operatives

Co-operatives exist to carry on an industry, trade or business for the mutual benefit of its members. They cannot be charities, but are a useful vehicle for certain types of social enterprises.

Community Benefit Societies

Community benefit societies are set up primarily to benefit those who are not members of the society in a way that is in the interests of the community. Such organisations can be charities, but do not have to be, and whether or not they are charitable will be determined by the wording of their constitution. Those that are charities are exempt from the requirement to register with the Charity Commission, and so will not have a charity registration number, but are subject to many of the laws governing charities and on registration with HMRC will benefit from the tax advantages. All societies that are charities will have "charity" in their name or are obliged to state that they are a charity on their letterhead, emails and website.

Community benefit societies can have a substantial share capital and provide a return to investors, meaning that they can sometimes be appropriate for social enterprises.

Receiving grants from societies

Charitable, and sometimes non-charitable, Societies will have an asset lock prescribed by statute that prevents payment of its assets to a third party. However, payments to charities, community interest companies and registered social landlords are excluded from this asset lock, and so other charities can receive grants from such Societies notwithstanding any asset lock.

Contracting with a society

All Societies are registered by the Financial Conduct Authority, with whom they file their annual returns and accounts. The FCA maintains a public register which you should check before entering into a contract, to ensure that the Society in question exists and that you are dealing with it rather than an impersonator. Societies can use a trading name, but the name with which they are registered at the FCA should appear on their letterhead, emails and website, so they should be easy to find on the register.

Contracts can be effective even if they are not signed, or even in writing at all, but it is strongly advisable to obtain an appropriate signature on a written agreement as evidence of the contract. A Society can sign a contract in the same way as a company, broadly speaking. Therefore you would expect to see the signature of one of the directors (often called "committee members") or a sufficiently authorised employee or other representative, and the signature expressed to be "for and on behalf of" the Society. Determining whether an employee or other person is sufficiently authorised to sign on behalf of the Society is a matter of what is normal business practice: a supermarket check-out operator can sell you a lettuce but they can't sell you the supermarket!

A deed is a form of legal agreement that must be executed in a specific way, and is typically required for transfers of land or shares or for a power of attorney. A Society can have a seal, which it uses to execute deeds. If, as is common, it doesn't have a seal then it can execute deeds by the signatures of two directors or by the signatures of one director and the Society's secretary. Note that directors may be called board members or committee members in the Society's constitution and, if so, that should be reflected in the deed.

Powers

A Society's constitution is called its "rules". These will cover matters such as the power of the Society to borrow money, and will be the starting point for establishing whether a Society that you are dealing with has the power to do what is proposed.

Know who you are dealing with

Societies are ultimately controlled by their members. Members may be corporate bodies as well as people. However, there can be different tiers of membership with different rights and these will be specified in the rules.

The Society will be run by a board who owe to the Society the common law duties of a director. If the Society is a charity then the board members will also be charity trustees, and will be subject to those additional duties. The powers that are not exercisable by the board and the powers of the board to delegate to committees and paid staff or volunteers will be set out in the rules.

Changes in the law

Various changes to the law relating to Societies will be made in 2014. The most significant for organisations dealing with Societies are set out below.

Withdrawable Shares

The share capital of Societies can be made up of various types of shares, including withdrawable shares. These are shares which the member can withdraw from the Society at any time, receiving the nominal value of their shares back from the Society in return. This potential call on its capital can be disruptive for Societies and typically if it has withdrawable share capital its rules will specify the mechanism and notice periods required for withdrawing shares. From 6 April 2014 the maximum value of withdrawable shares that can be owned by a single member will increase from £20,000 to £100,000. This increase may make Societies more attractive vehicles for various forms of social enterprise investments. However, if you are contracting with a Society which has withdrawable shares then be aware that it could become considerably less solvent if its shares are withdrawn.

New Names

From 1 August 2014, new Societies will have to register as a "Co-operative Society" or as a "Community Benefit Society", but Societies in existence at that date will continue to be "Industrial and Provident Societies". At this stage, this is just a name change, and any of the three labels will mean an organisation incorporated under the Industrial and Provident Society Acts and registered at the FCA.

Changes to the Insolvency Regime

When Societies are threatened by insolvency, creditors have less options than they do in respect of insolvent companies. Proposed changes will give more flexibility, but will not make the law uniform with that which applies to companies. If you wish to take a charge over the assets of a Society, lend a Society money, give a Society credit or are concerned about the solvency of a Society which owes you money, then take specialist legal advice.

An update on the SORP(s)

On 18 March Deloitte held its half yearly update training for senior staff and clients. We were lucky enough to have a couple of guest speakers one of whom was Nigel Davies from the Charity Commission Accounting Policy Team. Nigel's talk helpfully covered not only the major changes from the current Statement of Recommended Practice for Charities (SORP 2005) but also an insight into the post consultation discussions and some indications of what might be in the final SORP.

Two SORPs

One of the most fundamental changes that Nigel talked about was the introduction of a FRSSE specific SORP. As a result of decisions taken in the European Union there are likely to be changes to small company reporting and the FRSEE in 2015/16. Therefore the Charity Commission has taken the two SORP approach on the basis that it will cause the least disruption for those charities who adopt FRS 102 following the 1 January 2015.

The FRSSE SORP to be issued this summer will support FRSSE 2015. The FRSSE SORP is simplified, it is the steady state option, although it may be the most disruptive as change will follow quickly upon change. FRSSE SORP still avoids the statement of cash flows.

Other changes following the SORP consultation

Some of the changes from the consultation draft that Nigel highlighted for us included:

- Advice has been incorporated on the Strategic Report (for medium and larger charitable companies).
- Larger charities must disclose their remuneration policy for senior staff.
- Statement of Financial Activities (SOFA) headings are simplified.
- Material fraud is no longer required to be disclosed (but is cited as an example of a material item that should be disclosed).
- Guidance on the retail gift aid scheme has been added.
- Grant makers with a website can publish their list of grant recipients on the web rather than as a note.
- A reference has been added to holiday pay accruals (for charities applying FRS 102).
- The heritage assets definition is no longer linked to having preservation or conservation objects.

Next steps

The approval of the Financial Reporting Council is now required and it is hoped that there will be a web launch by the end of June (at the earliest), with hard copies following in the autumn. The SORP micro-site will be maintained with e-versions of the SORP and examples and other assistance will be added subject to resources. The new SORPs will apply to all charities for years beginning on or after 1 January 2015.

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