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

Welcome to the Spring 2016 edition of Pulse.

I am pleased to present the latest issue of Pulse. In this issue, there are articles on the Modern Slavery Act, Ethical Investment and VAT. As ever, these are important topics that cover latest developments in the sector.

Happy reading!

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.

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Modern Slavery Act 2015

The Modern Slavery Act 2015 ('the Act') was published in March 2015,[1] in response to heightened concern around slavery, human trafficking and forced labour in global supply chains. In 2015, the International Labour Organisation (ILO), an agency of the United Nations, estimated that 21 million people are victims of forced labour around the world, generating approximately US$150 billion a year in illicit profits.[2] The Act provisions are designed to encourage business to tackle modern slavery head on.

In summary:

- All organisations with UK operations and turnover in excess of £36 million, with a year end on or after 31 March 2016 are required to publish a slavery and human trafficking statement on their website as soon as reasonably practicable after the year end. Possibly either alongside or very shortly after they issue their annual report.

- This statement must set out the steps that an organisation has taken during the financial year to ensure that no slavery or human trafficking is taking place with the organisation or its supply chains, including all third party suppliers and sub-contractors.

- The extreme case of modern slavery is not the only area of labour exploitation that is coming under increased focus by The Department of Business and Skills (BIS) and by governments around the world.

What is modern slavery?

Modern Slavery is a broad term for the criminal activity for certain aspects of the abuse of human rights. It includes the offences of slavery, servitude and forced or compulsory labour, as well as human trafficking.

Slavery: the key element of slavery is the deprivation of freedom and behaviour on the part of the offender as if they own the victim.

Servitude: forcing an individual to provide services through the use of coercion. This includes the obligation for the victim to live on another person's property and being unable to change this condition.

Forced or compulsory labour: work or service is obtained from an individual under the menace of any penalty. They have not offered this work or service voluntarily.

Human trafficking: the offender arranges or facilitates the travel of the victim with a view to that person being exploited – this can be even whether the victim consents to the travel, as they may have been deceived or unduly influenced.

BIS has also released a consultation **"Tackling Exploitation in the Labour market"**[3] which draws attention to less serious offences of exploitation not captured by the Modern Slavery Act.

To go beyond compliance with the Act, charities could also review supply chains to ensure that there is no exploitation of workers, for example being forced to endure sub-standard accommodation, excessive hours, recruitment fees, or illegally low wages.

What is the reporting requirement?

The statement should set out what activity the organisation is undertaking to eliminate slavery and human trafficking from their supply chains and from their own business, or a statement that the organisation has taken no such steps.

The Act does not specify the content or structure of the statement, but does suggest six areas which may be included:

- information about the organisation's structure, business and supply chains;

- its policies in relation to slavery and human trafficking;

- information on due diligence processes in relation to slavery and human trafficking in its business and supply chains;

- the parts of the business and supply chains where there is a risk of slavery and human trafficking taking place, and the steps it has taken to assess and manage that risk;

- its effectiveness in ensuring that slavery and human trafficking is not taking place in its business or supply chains, measured against such performance indicators as it considers appropriate; and

- the training about slavery and human trafficking available to its staff.

Organisations falling within the requirements would need to give careful thought to the statement and how they would research its accuracy. The statement would need to be published on the organisation's website and would need to be signed off by a Trustee (or equivalent): there is an expectation that it would be published at the same time as the charity's annual report.

More detailed guidance is available in annex E of the government's document **"Transparency in Supply Chains etc. A practical Guide"**.[4]

It is important to note that by making the statement the organisation is not required to guarantee that the entire supply chain and organisation is slavery free, the organisation is just required to detail all the steps it has taken to ensure that no slavery or trafficking is taking place.

Key areas of consideration

Charities should already be considering supply chain risks within their operational activities – the Act aims to focus attention on considering the whole chain and the impact and use of third parties and sub-contractors. Charities operating in high risk countries will need perhaps to be particularly conscious of their activities and the activities undertaken by others on their behalf.

1 Modern Slavery Act 2015 http://www.legislation.gov.uk/ukpga/2015/30/contents/enacted

2 International Labour Organisation http://www.ilo.org/global/topics/forced-labour/lang--en/index.htm

3 BIS https://bisgovuk.citizenspace.com/lm/tackling-exploitation-in-the-labour-market

4 Guidance issued under section 54(9) of the Modern Slavery Act 2015 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/471996/Transparency_in_Supply_Chains_etc__A_practical_guide__final_.pdf

The Act came into force in October 2015, and charities making a statement in relation to their March 2016 year end will be expected to reflect on at least that six month period.

In anticipation, areas to consider now include:

- adding the requirements to the risk register to ensure ownership and oversight;
- critically examining supply chains to identify potential risk areas;
- focussing on all areas of operations for example including investments and grants;
- reviewing internal policies and procedures for procuring new suppliers or commencing any new activity; and
- reviewing internal training and HR procedures in respect of modern slavery to ensure all staff have had appropriate training, are aware of company policies and that there is an effective whistleblowing policy if modern slavery is found.

Non-compliance or a negative/no steps statement runs the real risk of reputational damage.

The impact of ethical investing on returns, volatility and income

Ethical investing is now undoubtedly a mainstream issue. Charities are increasingly adopting more ethical investment approaches to ensure their capital is aligned with their mission, and investment managers are being challenged to meet this growing demand.

In the meantime, however, there have been few studies of the impact of imposing ethical constraints on an investment portfolio.

Against this backdrop of minimal research, Newton commissioned Dr Chendi Zhang and Dr Lucius Li of Warwick Business School to analyse the impacts of commonly applied ethical screens, with the aim of providing an independent, academic starting point for charities considering implementing an ethical policy.

Size and scope of the study

Dr Zhang and Dr Li's paper considers the more traditional 'sin' sectors – tobacco, alcohol, weapons, pornography and gambling – as well as fossil fuels, a sector which has become an area of focus more recently. The study evaluates the impact of excluding these areas from investment portfolios in three ways: in terms of performance, yield and volatility. In some cases, a sector-wide screen is applied (e.g. the tobacco sector), while in others, such as pornography, a materiality threshold is used to identify businesses deriving significant revenue from particular activities.

The study is far-reaching; the analysis covers over 10,000 stocks in 28 developed and emerging markets, and 1,283 US corporate bonds, in a sample period running from 2004 to 2015.

Key findings: The impact of the five key 'sin' screens

Dr Zhang and Dr Li's findings clearly indicate that the traditional 'sin screens' have in general reduced returns over the period (see exhibit 1). While it is intuitive that a restriction in the universe reduces returns, the size of the performance reduction is perhaps less than expected.

Within those headline numbers, there have been significant variations between regions. Furthermore, excluding the traditional five areas does not reduce returns in all regions – in Europe (ex UK) the sin screens had a 0.01% p.a. positive impact on performance.

Exhibit 1. Sin screens – summary impact analysis

Region	Performance impact (p.a.)	Volatility impact	Yield impact
Developed markets	Reduces 0.3 – 0.5%	Increases 0.3 – 0.4%	Reduces 0.05 – 0.06%
UK	Reduces 0.5 – 1.0%	Increases 0.8 – 0.9%	Reduces 0.05 – 0.08%
US	Reduces 0.3%	No significant impact	Reduces 0.02 – 0.03%
Europe ex-UK	Increases 0.0 – 0.3%	Increases 0.6%	Reduces 0.04 – 0.07%
Asia Pacific	Reduces 0.1 – 0.4%	Increases 0.3 – 0.4%	Reduces 0.03%
Emerging markets	Reduces 0.0 – 0.1%	Increases 0.2%	No significant impact
US corporate bonds	No significant impact	No significant impact	No significant impact

The individual screens themselves have also shown significant variability. For example, excluding alcohol in the US had a negative impact of -0.03% p.a., while in the UK it benefited performance by 0.57% p.a.

Threshold based screens

Portfolios which implement threshold-based sin-stock screens excluded more of the investible universe by market capitalisation (10.52%) when compared with sector-only screens (8.77%). The portfolio theory suggests the more one reduces an investible universe, the greater the impact on volatility, and this is supported by Dr Zhang's findings.

Impact of 'sin' screens varies over time

During and after crisis periods there were significant reductions in returns from ethically restricted developed market portfolios. From 2011 to 2013, the reduction in returns from excluding 'sin' stocks was the largest, at -0.9% p.a. Conversely, exclusion of sin stocks had a positive impact on returns (+0.2% p.a.) from 2004 to 2006. This highlights just how much the impact of ethical exclusions has varied over time. Exhibit 2 demonstrates the range of the impact of 'sin' screens over the period.

Exhibit 2. Range of impact of 'sin' screens

Region	Range of impact (p.a.)
Developed markets	-0.9% to +0.2%
US	-0.8% to +0.1%
UK	-2.4% to +1.8%

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Economic backdrop

During periods of economic expansion, investors are compelled to invest in growth-orientated sectors of the market. Conversely, during periods of depressed growth and heightened uncertainty, investors may seek 'havens' – sectors characterised by higher yields and greater liquidity. Tobacco and oil & gas producers are examples of these sectors.

Key findings: The impact of fossil fuel screens

The last two years have seen a rise in interest in charities applying some form of climate change-related restriction to their investment portfolios. Dr Zhang and Dr Li looked at the impact of broad sector-based screens on portfolio returns, volatility and income over the course of the study and found no significant impact.

Overall, exclusion of fossil fuel stocks increased portfolio returns by 0.02% p.a., lowered volatility by 0.02%, and reduced the dividend yield by 0.03% p.a. The *de minimis* impact on yield is perhaps surprising given that oil and gas has historically been heralded as one of the best-yielding sectors, providing charity investors with a source of stable, predictable income.

As with the five traditional 'sin' screens, the paper found that the impact of fossil fuel screens varied considerably over the period of the study.

Fossil fuel prices

The research demonstrates, as one would expect, a linkage between fossil fuel stock performance and fossil fuel prices in developed markets. During periods of sustained fossil fuel price weakness, the benefit of avoidance was as much as 0.86% between 2012 and 2014.

Emerging markets portfolio

Interestingly, emerging-market portfolios benefited significantly from a fossil fuel exclusion policy over all rolling three-year periods, even when oil prices were rising rapidly. Over the period of the study, exclusions increased portfolio returns by 1.1% p.a., increased volatility by 0.8% p.a., and had an insignificant negative impact on yields. It could perhaps be argued that this positive effect is attributable to the fact that many emerging-market oil companies are under state control, and as a result they are not necessarily managed with shareholders' best interests in mind.

Exhibit 3. Fossil fuel screens – summary impact analysis

Region	Performance impact (p.a.)	Volatility impact	Yield impact
Developed markets	No significant impact	No significant impact	Reduces 0.03%
UK	Increases 0 – 0.2%	Increases 0.1 – 0.2%	Increases 0.03%
US	Reduces 0.2 – 0.3%	Increases 0.1%	Increases 0.01%
Europe ex-UK	No significant impact	Increases 0.1 – 0.2%	Reduces 0.06%
Asia Pacific	No significant impact	Reduces 0.1 – 0.2%	Reduces 0 – 0.01%
Emerging markets	Increases 1.1 – 1.2%	Increases 0.7 – 0.8%	Reduces 0.06%
US corporate bonds	No significant impact	No significant impact	No significant impact

Exhibit 4. Range of impact of fossil fuel screens

Region	Range of impact (p.a.)
Developed markets	-0.3% to +0.9%
US	-0.5% to +0.5%
UK	-0.9% to +1.8%
Emerging markets	Increases returns in all time periods; max 2.6% p.a. 2008 - 2010

A starting point for charities

Ethical investing considers both financial and non-financial aspects of investing. It is therefore important for charities, their trustees and their investment managers to be aware of the potential impact on portfolio returns, volatility and income when building ethical investment policies and deciding how these will be implemented. Dr Zhang and Dr Li's research underscores the importance of these considerations. Importantly, the study also demonstrates how the impact of ethical exclusions can vary over time. Charities need to be aware of this variability and factor it into their decision making.

We, at Newton's, hope that Dr Zhang and Dr Li's independent work is a useful starting point for charities; while the past is not a perfect guide to the future, we believe their research provides some important points for charities to consider.

For more information about Newton's findings[5] and to view the full paper, please visit www.newton.co.uk/charities.

5 The research and data contained in this document was commissioned by Newton in 2015.

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VAT and membership or supporter schemes

VAT is a notoriously complicated tax and charities face some of the most difficult challenges in ensuring they remain compliant with the law whilst taking advantage of the various VAT reliefs available to them. A common issue faced by the not-for-profit sector is correctly accounting for VAT on income received in respect of membership or supporter schemes.

Not for profit organisations typically offer a variety of levels of membership at different price levels and provide the member with a range of benefits. For example discounted tickets or free entry to the organisation's property (e.g. museums/galleries/exhibitions etc.), copies of regular publications such as magazines or brochures and guaranteed attendance at annual events such as fundraising dinners.

Single or multiple supply?

Such schemes create complexities from a VAT accounting perspective for a number of reasons. It is firstly necessary to establish whether a single or multiple supply is being made in return for the subscription payment. A single supply arises where there is one principal benefit obtained from joining the scheme and all other benefits are ancillary. A multiple supply is one where each benefit is considered to be an aim of joining the scheme in its own right. This judgement can involve an element of subjectivity which can lead to uncertainty on the VAT position.

Where a membership scheme consists of multiple supplies, it is usually necessary to agree an apportionment method with HMRC, perhaps based on the relative cost or value of each benefit, in order to determine the proportion of the subscription payment that should be allocated to each benefit. VAT is then accounted for where appropriate based on the VAT liability of that benefit.

Has it changed?

Problems often arise where the package of benefits offered to members changes over time but the VAT apportionment calculation is not updated. Regular communication between the membership team and finance team is essential to ensure the tax implications of proposed changes are fully considered. In addition, an element of the subscription payment is often zero-rated, on the basis that one of the benefits received by members is a zero-rated brochure or magazine. It is important to note that as such publications become increasingly available in electronic form, it may no longer be appropriate to apply the zero-rate of VAT to this benefit. Lastly, we often see confusion arising between a qualifying charitable donation for Gift Aid purposes and a donation which is outside the scope for VAT purposes – Gift Aid and VAT are not aligned in this area and this is a common mistake that can lead to charities under-paying VAT on income.

This is an area of increasing focus for HMRC and we are helping a number of our clients to ensure that risks are managed appropriately in respect of their membership/supporter schemes.

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