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Summer 2013

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

Welcome to the Summer edition of PULSE; our quarterly publication that deals with important and topical issues affecting charities across legal, accounting and investment matters. The relatively 'quiet' summer period will, I suspect, be spent by those involved in the sector primarily on issues under consideration that will shape the new SORP.

However, more importantly in my view, is the constant news about charities, some well known and very resourceful, facing huge reduction in their income. As the economic austerity measures bite, more purses are tightened up and the result is the inevitable drop in donations. Charities should therefore consider not only alternative ways of fundraising, but also innovative measures that may enable them to reduce their dependence on direct donations from the public.

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.

Reza Motazedi
rmotazedi@deloitte.co.uk

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

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

Draft SORP – consultation document published July 2013

In a nutshell

A consultation draft of the new Charities Statement of Recommended Practice ('the draft SORP') has been published by the Charity Commission and the Office of the Scottish Charity Regulator (OSCR) which will be applicable for periods beginning on or after 1 January 2015.

The draft SORP provides guidance to those preparing accounts under either FRS 102 or the FRSSE.

Some of the key proposals are as follows:

- The Trustees' report will need to be more balanced, with increased emphasis on public benefit, successes, failures and lessons learned.
- Larger charities will now need to disclose the principal risks and uncertainties which they face and the plans in place to mitigate those risks and uncertainties.
- Net gains or losses on investments will be disclosed separately after income and expenditure.
- Charities preparing their accounts under FRS 102 will have to produce a statement of cash flows regardless of size or whether they are a subsidiary of another charity.
- Key management personnel remuneration may be disclosed by individual.
- Increased clarity for grant accounting, recording commitments and pension liabilities.

Responding to the consultation

Responses to the consultation are requested by 4 November 2013. We encourage all charities to respond.

Further information

For further detail please see our Charities Alert July 2013 available on our website www.deloitte.co.uk/charitiesandnotforprofit.

Jeremy Wells
Client Director
Charities Team
Newton Investment
Management Ltd

Sustainable portfolio 'withdrawal rates' for charities

"A charity… will need to consider balancing capital growth and income return in order… to meet its aims and its beneficiaries' current and future needs."
The Charity Commission, CC14 (2011)

Today's harsh economic climate is enormously challenging for charities: previous levels of withdrawals may appear unsustainable, but cutting spending to preserve assets may be undesirable or even impossible. Jeremy Wells of Newton Investment Management reports.

The current financial backdrop questions assumptions about future returns and, therefore, reasonable levels of withdrawal that will protect long-term value, after inflation.

Asset allocation and returns

We analysed the WM Common Investment Fund Universe to determine an asset allocation and consequent returns for an 'average' charity. Based on current market yields, the typical charity portfolio would yield 3.0%:

Asset class	Weight %	Yield %	Index
UK equity	39.7	3.4	FTSE All Share
Overseas equity	37.7	2.5	FTSE World ex UK
Bonds	12.1	2.7	FTSE All Stock
Property	5.5	6.8	IPD All Prop
Cash/other	5.0	0.5	Base rate
Total	100.0	3.0	

This highlights that an aspiration to spend 4% per annum from the endowment will require some annual withdrawal of capital, as the weighted average portfolio yield is only 3%. A portfolio would therefore need to achieve capital growth in addition to income.

If a charity is indifferent about whether it draws expenditure from income or capital, the key consideration will be total return. We considered the long-term inflation-adjusted returns of the main asset classes, based on work by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School, which looks at returns for equities, bonds, and cash from 1900 to 2012:

Asset class	Weight %	Real return %
UK equity	39.7	5.2
Global equity	37.7	5.0
Bonds	12.1	1.5
Property	5.5	4.3
Cash/other	5.0	0.9
Total, and weighted-average yield	100.0	4.4

Over the 113-year period from 1900-2013, inflation (as measured by Dimson, Marsh and Staunton) has averaged 4.0% a year: on a nominal basis, the total return for our average portfolio would therefore be 8.4%, which would support a 4% withdrawal.

After management fees and transactional costs are subtracted, we conclude that 3.5% to 4% p.a. has been a reasonable, sustainable level for distributions.

Trustees may have shorter timescales than our 113-year analysis above: we therefore reviewed shorter periods to see how the analysis varies. Our analysis of individual decades from 1900 to 2012 using the Dimson, Marsh and Staunton data, showed that the average charity delivered very divergent nominal and real total returns in these decades. Trustees may ask what the probability is of withdrawing a consistent amount over any 10- or 25-year period, while being able to 'hand over' the portfolio with the principal value intact (after inflation). We analysed the period 1900-2012 and the various rolling 10 and 25-year periods within it to determine how often the principal of a balanced portfolio of equities and bonds would have equalled or exceeded the inflation-adjusted original principal, after allowing for annual distributions (and annual fees of 0.5%).

Our analysis allowed total gross annual withdrawals from 2.0% to 6.0%. The distribution between equities and bonds varied from 100% equities (half UK, half overseas) and vice versa. We conclude, first, that the probability of maintaining the purchasing power of the principal over a long period (25 years) increases as the annual withdrawal amount decreases. Second, a higher percentage of equities improves the probability of maintaining the purchasing power of the principal (albeit with increasing volatility). Even over 25-year cycles, no combination of asset allocation and withdrawal rate gave a 100% probability of maintaining real purchasing power of the principal. Significantly, over a 10-year horizon, there is a one in five chance that even an all-equity portfolio distributing just 2% per annum would have *failed* to protect the real value of capital, demonstrating that 10 years is not 'long-term' for investments.

Volatility

With a total-return approach, basing a sustainable distribution policy on a moving average over several years of the valuation of the underlying portfolio may smooth the volatility of expenditure levels. Research from the US by Bernstein Global Wealth Management (January 2011), demonstrated that smoothing annual distributions reduces volatility of income and also reduces significantly the chance of an annual distribution decline of 10% or more.

Being cautious or taking risks

A small over- or under-distribution has a significant effect on the real value of the portfolio over 20 years. Based on our analysis, taking 0.5% p.a. out of a portfolio above the sustainable level will reduce the real value of the portfolio by 10% by the end of the 20-year period. Taking 2% per annum above the sustainable level would reduce the real value by 33%. Conversely, taking 0.5% less than the sustainable level would add 10% to the real value of the portfolio by the end of the 20-year period, and under-spending by 2% a year would add nearly 50% to the real value.

Practical approaches

Our analysis implies that an expenditure rate much above 3% (including fees) *carries material risk of eroding the real value of the capital in the future.* What actions or strategies could trustees consider to balance the needs of current and future beneficiaries?

- **Spend less.**
- **Spend income, but invest for (more) growth.**
- **Avoid the downside.**
- **Enhance your returns through active management.**
- **Use a 'smoothing formula',** basing a distribution policy on a moving average over several years of the valuation of the underlying portfolio.
- **Consider whether your charity is perpetual,** or whether it may be better to spend assets in a planned way over a pre-determined horizon to address current and medium-term needs, rather than planning for unknown eventualities in 50 or 100 years.

The most important implication is that charity trustees should address withdrawal levels as part of the regular review of their investment portfolio. As CC14 2011 states: "A charity needs to be clear about what it wants to do, how it intends to do it and what the timescale for delivery will be…" In uncertain times, this challenge is as great as ever.

This article is an abridged version of a longer paper. If you would like further information or a copy of the paper please contact Pamela Cowling at Newton on Pamela_cowling@newton.co.uk.

We thank Elroy Dimson, Paul Marsh and Mike Staunton for their permission to use extensively their long-term data, and Justin Foo for his help in interpreting and presenting this data, and his additional analysis and research. Their data and guidance has been invaluable in producing this report.

Group charities – a legal perspective

Donald Taylor
Charities and not-for-profit team
Charles Russell LLP Solicitors
Donald.Taylor@charlesrussell.co.uk

Many charities control other, subsidiary, charities that form part of their corporate group. This parent/subsidiary relationship raises a number of legal issues that need careful consideration. What principles should inform the decision making of the parent charity in relation to its subsidiary? How should the boards of the charities be composed and what circumstances should be avoided to ensure that each charity is protected from the liabilities of the other?

Who is the boss?

Where a charity is the sole (or majority) member of a subsidiary charitable company, both charities will be part of the same group. A member can usually change the subsidiary charity's constitution and appoint and remove its board of trustees. These are extremely powerful tools with which to influence and ultimately control the subsidiary charity.

The Charity Commission asserts in its guidance that a member of a charitable company must exercise its constitutional rights in the best interests of that charity. The Commission does though concede that there is no direct authority for this proposition. In practice, it is unlikely that most resolutions of a charity's membership aren't, in the membership's reasonable opinion, in the best interests of their charity. An arbitrary or capricious resolution of the membership could be challenged on this basis, though. This legal uncertainty means that a parent charity should take care when making decisions in its capacity as member of a subsidiary charity. Ideally, such decisions can be framed as being in the best interests of both charities, and so no conflict arises. Where that is not obviously the case, the minutes of the meeting should be carefully drafted and professional advice should be obtained if difficulties could arise.

If the subsidiary charity is a charitable incorporated organisation, then the matter is more straightforward as the member will have a duty to exercise its constitutional rights in good faith and in a way that is most likely to promote the charitable purposes of the subsidiary charity. Where there might be uncertainty, or the member's resolution appears primarily to benefit the parent charity, the minutes recording the decision should again be carefully drafted and professional advice sought where appropriate.

Who should be on the board?

There are three main aspects to consider in respect of the composition of boards of trustees of charities in a group: competencies, communication and conflicts of interest.

Every board of trustees should aim to have a balance of competencies, so that it is fit for purpose. A parent charity should always keep this principle at the forefront of its decision making when appointing trustees to the board of the subsidiary charity. What combination of skills and experience would most benefit the charity given its area(s) of activity and the various circumstances?

Each board of trustees must have good lines of communication with the other charities in the group, so that a consistent group strategy can be maintained where it is in the best interests of both charities. Other communication channels may be in place, especially where there are substantial numbers of employees, but it is invariably advisable to have at least one trustee who serves on both the parent board and the subsidiary charity's board to ensure coherence in high level decision making across the group. Appropriate mechanisms can be put in place to govern the manner in which any dual trustee reports back to the parent charity about the activities of the subsidiary charity. Protocols are often agreed, under which particular office holders from each charity meet regularly.

Each board should have a sufficient number of independent trustees so that it can form a quorum to pass resolutions on intra-group matters, such as a cross charging or licensing agreement between the charities. Furthermore, those independent trustees will be able to authorise the conflicts of interests of the other trustees. It is usually advisable to review the constitutions of the charities in a group to ensure that they permit the trustees to authorise conflicts where appropriate, and to minimise the administrative inconveniences that can arise in respect of conflicts of interests. It may be useful to expressly authorise some conflicts, particularly conflicts of loyalty, in the constitutions.

Losing ring-fenced liability?

Often subsidiary charities exist in order to ring fence the potential liabilities of the subsidiary and so protect the assets of the parent. This ring fencing of risk within a group can be very advisable, but it can sometimes be dangerous to rely on it as there are various common circumstances where the ring fencing will fail to protect the other charity in the group.

A parent charity must take care to avoid becoming a shadow director of the subsidiary charity. A parent charity will be a shadow director where the board of trustees of the subsidiary charity is effectively a puppet board, with the parent charity being the controlling mind of the subsidiary charity behind the scenes. This may occur where all of the strategic decisions are made by the board of the parent charity and the board of the subsidiary charity merely rubber stamps those decisions.

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

Shadow directorship can potentially expose the parent charity to all of the duties and therefore liabilities of the subsidiary charity's trustees. To demonstrate that each charity is acting independently, a parent charity should ensure that each charity's board of trustees carefully record minutes of their own meetings which show independent decision making on major issues, even if the two boards ultimately decide to follow the same group strategy.

If a charity guarantees the other charity's obligations, it may be in breach of charity law and will be exposed to that other charity's liabilities to the extent of its guarantee. It could also become exposed through entering into tri-partite contracts between the charities and a third party, or by entering into contracts that purport to impose obligations on the corporate group as a whole. For example, the terms on which banks provide current account facilities sometimes attempt to impose obligations on all of the companies within a group, which may be appropriate in commercial circumstances but will almost certainly be inappropriate for groups of charities.

If the connected charities enter into the same VAT group then they may become liable for unpaid VAT on the insolvency of their fellow group charity. Similarly, if the charities are in the same defined benefit pension scheme then the failure of one can impose additional liabilities on the other. Finally, group charities often operate in the same "reputational bubble" which means that, although they are legally ring fenced from each other's liabilities, in practice they may incur costs on the insolvency of their "ring-fenced" group charity, whether to purchase relevant intellectual property or to pay off industry creditors.

Conclusion

Careful consideration must be given to the decision making of a parent charity when acting in its capacity as member of a subsidiary charity, and legal advice sought where appropriate. When appointing trustees to a subsidiary charity, the parent charity should take into account the need for a balance of competencies, communication between the two boards and how conflicts will be dealt with. It is possible to accidentally and unnecessarily expose group companies to each other's liabilities and so vigilance is essential for groups of charities to guard against requests for guarantees or indemnities for example.

CIOs… In full force?

It is no longer news that CIOs have, finally, arrived!

After 400 years, and many debates, this format and legal structure is the only one in operation that has been exclusively designed for registered charities.

The intention behind their "invention" is that it provides the benefits of incorporation to registered charities, under the sole regulation of the Charity Commission. Therefore, charities should, in theory, find it easier to deal with one regulator and not worry about the dual filing requirements with both the Charity Commission and Companies House. However, there is more to CIOs; it is really the overcoming of the anomalies in the Companies Act and replacing them with charity specific rules that really make CIOs a more attractive option. They do have their shortcomings; but in the main they are simple to operate and, in theory, easy to register. If you require more details about CIOs, please consult our publication *Charitable Incorporated Organisations: A guide to establishing your charity as a CIO*, which is available on our website www.deloitte.co.uk/charitiesandnotforprofit.

However, despite the apparent attraction of CIOs, their suitability and the substantial time that has been devoted to their development, they are yet to really take off. Why? Is it that the concept was wrong; ill-conceived? Is it because due to the downsizing of the Charity Commission they don't have proper resources to devote to the incorporation of these? Or is it the reluctance of the sector to try out something different; and charities waiting for each other to take the plunge; to see if establishing a CIO turns out to be a disaster before they commit to them? Time will tell, but the opportunity is there to either establish or convert into a CIO; the sector should not miss the chance to take up the offer.

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