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Summer 2015

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

Hello and welcome to the summer 2015 addition of Pulse.

As I write this, I reflect on the preparation taken by charities ahead of adoption of the new SORP. We are seeing considerable thought and effort being put into this area and are likely to see further activity within the next few months.

This addition is packed with legal, investment and technical articles.

These will provide a great background to developments currently attracting attention.

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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# Charities (Protection and Social Investment) Bill

*This bill, formerly known as the Draft Protection of Charities Bill (initially published on 22nd October 2014) was announced as part of the Queen's Speech on 27th May 2015. The aim of the Bill is to protect charities in England and Wales by giving the Charity Commission either new or strengthened powers to tackle abuse of charities more effectively and efficiently and to maintain the "high public trust in charities". Much of this responds to requests from the Commission itself for increased powers.*

The proposed legislation would tighten criteria for people to become a charity trustee or senior manager; extend the existing criteria which disqualify a person from being a charity trustee to people with unspent convictions for criminal offences including terrorist offences, money laundering and various other offences; as well as extending disqualification to cover senior management positions in charities.

A Joint Committee of peers and MPs, chaired by Lord Hope of Craighead, published its report on the Bill on 25th February 2015, in which it concluded that, for the most part, the Committee was supportive of the Government's proposals; but it nevertheless made some detailed recommendations and had concerns that effective safeguards must be in place to ensure charities and their trustees are treated fairly by the Commission.

### The provisions – Charity Commission powers

The Government response to the Joint Committee's comments was published on 26th March 2015. Whilst the Government took on board most of the Committee's recommendations, it did not agree with all of them. Key provisions within the Bill include granting the Commission powers to:

- **Issue a statutory warning to a charity or charity trustee**, which could be as a result of a breach of trust or duty, as well as for failure to comply with either a requirement of the Charities Act 2011 or an order or direction of the Commission. A recipient of the statutory warning would be given an explanation of the reasons for the warning and an opportunity to make representations. It would provide the Commission with an additional tool lying in between issuing guidance and the opening of an inquiry. Failure to respond adequately to a statutory warning may be considered an act of misconduct or mismanagement which could result in the Commission using its other compliance powers, including disqualifying a trustee. This is distinct from failure to follow specified good practice, which would not in itself be considered evidence of misconduct or mismanagement; but the onus will be on charity trustees to demonstrate how they have complied with their legal duties;

- **Suspend a trustee for up to 24 months**;

- **Take into account an individual's misconduct or mismanagement outside of the charity** with which he or she is involved insofar as that conduct is relevant to the administration and management of that charity. A number of parties have requested that the Government improve the clarity of drafting of this provision so that trustees will have greater certainty about the implications of their behaviour;

- **Establish a scheme, during an inquiry, in relation to a charity where there is either evidence of misconduct or mismanagement or a need to protect charity property or secure its proper application.** The criteria for removal of a trustee or office holder would not change: the Commission would still require evidence of both misconduct or mismanagement and a need to protect charity property;

- **Continue with the process of removal and disqualification of a trustee even if a trustee were to resign** in an attempt to avoid the sanction;

- **Remove a disqualified trustee** if they continued to remain in their position once disqualified;

- **Direct trustees to wind up a charity** in certain circumstances and transfer resources elsewhere;

- **Direct the application of charity property** in the event that the person is either "unwilling" or "unable" to do so, rather than just "unwilling" as is currently the case. On this point, the Government agreed to explore the Committee's recommendation to include a statutory protection for financial institutions where compliance with a direction of the Commission might constitute a breach of contract;

- **Automatically disqualify trustees who have committed certain offences**, including money laundering, bribery, misconduct in a public office, perjury and perverting the course of justice; and offences under terrorism legislation;

- **Disqualify a person from being a charity trustee in relation to all charities, specified charities or classes of charity.** This would insert a new section 181A into the Charities Act 2011. The Commission may use this power only if it is satisfied that (i) the person is unfit to be a charity trustee or trustee for a charity (either generally or in relation to the charities or classes of charity specified or described in the order); and (ii) making the order is desirable in the public interest in order to protect public trust and confidence in charities generally or in the charities or classes of charity specified or described in the order; and (iii) one or more of the following conditions are met in relation to the person:

  – the person has been cautioned for a disqualifying offence;

  – the person has been convicted or cautioned for an offence overseas and the act constituting the offence would have amounted to a disqualifying offence if committed in the UK;

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– the person has been found by HMRC not to be a fit and proper person to be a manager of a body or trust;

– the person was a trustee, charity trustee, officer, agent or employee of a charity at the time when there was misconduct or mismanagement in its administration for which the person was responsible or privy to or which their conduct contributed to or facilitated;

– the person was an officer or employee of a body corporate at a time when the body was a trustee or charity trustee for a charity and there was misconduct or mismanagement in its administration for which the person was responsible or privy to or which their conduct contributed to or facilitated;

– any other past or continuing conduct by the person, whether or not in relation to a charity, is damaging or likely to be damaging to public trust and confidence in charities generally or more specifically.

Concerns have been expressed about the lack of clarity and need for increased safeguards associated with this discretionary power. The Government did agree to work with the Commission to refine the clause and consider additional factors which could be included in the Bill to narrow the purposes for which the power could be used.

### The provisions – Charity Commission responsibilities

The Bill also provides for certain relatively uncontroversial requirements on the part of the Commission to:

- maintain a register of all persons disqualified by the Commission;
- prevent a disqualified person who is a director of a corporate trustee of a charity from participating in decisions about the charity's affairs (intended to close a loophole which otherwise allowed a disqualified individual from participating in the corporate decisions of a charity).
- require a review of the Act at least once every 5 years.

### The Queen's speech 2015

During the 2015 Queen's Speech, it was announced that, in response to the Law Commission's recommendation, the Bill will include a *statutory power for trustees to make social investment*. Until now there has been uncertainty in the sector about the ability of trustees to engage in social investment.

Furthermore, the Government has included provisions in this most recent draft which were not in the initial draft but were suggested at the proposal stage; namely *giving the Commission powers to direct charities not to take certain actions and an extension of the proposed ability to disqualify people from being charity trustees to include senior management positions in charities.*

The Bill was introduced to the House of Lords on 28th May 2015.

## The hunt for yield

*With returns from traditional sources of income at historic lows, many investors are being forced to take on more risk by 'reaching for yield', which can be at the expense of capital. In this article, we explain why we believe an active and disciplined investment approach could provide income-seeking charity investors with better prospects for long-term capital preservation.*

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The investment backdrop for an income investor is almost unrecognisable from a decade ago. Income from low-risk investments such as cash and government bonds has all but vanished, with over half the world's government bonds yielding less than 1% at the end of March 2015. In just 18 months, the yield on a 30-year UK gilt has fallen from over 3.5% to just over 2.5%. For many charity investors, this means that long-dated gilts are now pulling down their portfolio's income rather than making a positive contribution, and need to be supplemented from elsewhere in the portfolio.

Exhibit 1: Low bond yields

| | Yield <1% | | Yield <0% | |
|---|---|---|---|---|
| | % World | % Local | % World | % Local |
| Australia | 0 | 0 | 0 | 0 |
| Austria | 1.0 | 100 | 0.4 | 36 |
| Belgium | 1.6 | 97 | 0.5 | 29 |
| Canada | 0.8 | 58 | 0.0 | 0 |
| Denmark | 0.4 | 100 | 0.1 | 32 |
| Finland | 0.4 | 100 | 0.2 | 42 |
| France | 5.6 | 92 | 2.1 | 35 |
| Germany | 4.8 | 100 | 2.7 | 56 |
| Ireland | 0.5 | 90 | 0.0 | 6 |
| Italy | 3.4 | 53 | 0.0 | 0 |
| Japan | 21.2 | 86 | 0.0 | 0 |
| Netherlands | 1.7 | 100 | 0.8 | 48 |
| Spain | 2.0 | 58 | 0.0 | 0 |
| Sweden | 0.3 | 100 | 0.1 | 35 |
| Switzerland | 0.4 | 100 | 0.2 | 56 |
| US | 13.9 | 37 | 0.0 | 0 |
| UK | 1.6 | 21 | 0.0 | 0 |
| Other | 0.2 | 88 | 0.0 | 6 |
| World | 59.8 | | 7.1 | |

Source: Bloomberg, Newton, March 2015. Based on bonds with a maturity greater than 1 year in the BofA Merrill Lynch global government bond index.

Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested. Past or current yields are not indicative of future yields. Any reference to a specific security, country or sector should not be construed as a recommendation to buy or sell this security, country or sector. Please note that portfolio holdings and positioning are subject to change without notice.

## Taking on more risk – a willingness to gamble

The current low-return environment is leading income-seeking investors to take on more risk in order to meet their objectives. Not only can such an approach push people outside their comfort zone, but since so many investors have been driven down this path, it has become quite a 'crowded' trade. This can be problematic because, if a large number of investors all decide they want to reduce risk at the same time, a lack of liquidity can drive significant price movements.

Behavioural finance, and the theory of loss aversion, can help us to understand why investors have been happy to take on more risk. As an example, try asking a colleague to imagine participating in a game show. Present them with a choice of two doors – A and B. If they choose door A, they will win £3,000; if they walk through door B, there is an 80% chance they will win £4,000, but a 20% chance they will win nothing. The chances are that they will pick door A, as everyone loves a certain win. Now offer them two more doors: walking through door C will result in a certain loss of £3,000, while door D presents an 80% chance of losing £4,000 but a 20% chance of losing nothing. The majority of people will select door D in order to avoid a certain loss, which is counter-intuitive. A computer would select door B (a probability-weighted outcome of winning £3,200) and door C (a probability-weighted outcome of losing £3,000, which is less than £3,200). When faced with a loss, people are more likely to gamble. Today, in the face of a loss of income, investors are willing to take on more risk in order to 'reach for yield'.

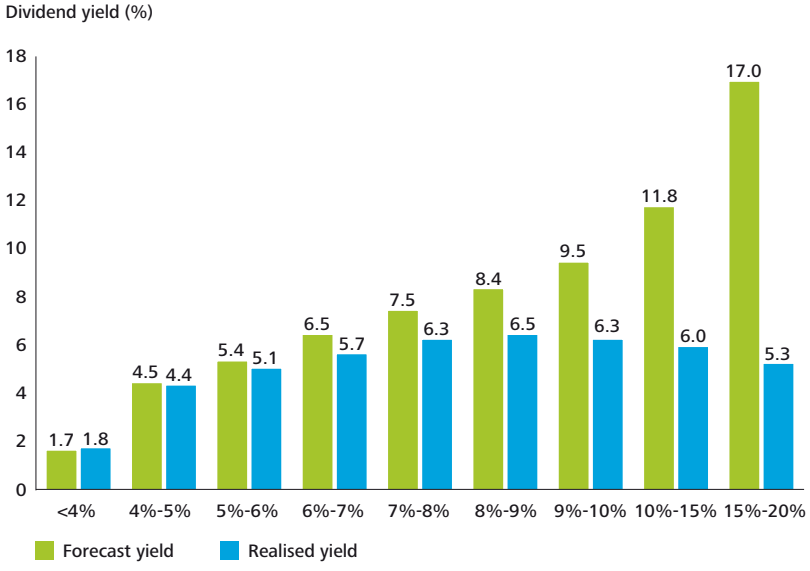
## Reaching for yield

For income investors, reaching for yield can mean taking on a greater degree of credit risk within bonds; investing in investment-grade and high-yielding bonds; or increasing allocation to equities, property and alternatives which may offer a higher yield. Some charity funds use derivatives to supplement the amount of income the portfolio would naturally generate.

The problem with reaching for yield is that it can be at the expense of capital growth. In order to protect capital and generate income as a long-term investor, it is important to maintain one's discipline. This means ensuring that your investment manager has a clear and robust process for constructing a portfolio and analysing securities, and that they can demonstrate how they can maintain this discipline over time. It is also important to understand the risks to income, such as what proportion of it is coming from riskier areas such as high-yield bonds or high-yielding equities, and what are the risks associated with any derivative strategy.

While equity valuations have moved up in recent years, we believe the outlook for returns and for income from this asset class continues to look attractive. However, within equities there is a significant divergence in the sustainability of dividends on offer. Those assets promising the highest yields often fail to deliver such rewards in reality.

Exhibit 2: Comparing forecast and realised dividend yields since end 1995 – 31 March 2014



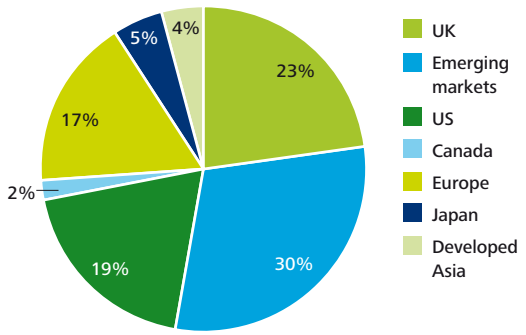

Source: SG Quantitative Research, Factset, 31 December 2014. For illustrative purposes only.

Past or current yields are not indicative of future yields.

## Active management

An active manager should be able to analyse where dividends are sustainable and construct a portfolio where the sources of income are diverse enough to protect investors from unforeseen events. They can also assist charity investors who want to generate a suitable and sustainable income while placing restraints on certain sectors, such as tobacco and energy. In our opinion, the UK remains one of the most attractive markets owing to its higher-than-average yield, good legal and regulatory structures and access to global trends, with the majority of FTSE 100 companies' turnover deriving from overseas sales. However, the income from the FTSE All-Share index is very concentrated, with just five stocks making up 45% of total income available. An active manager is likely to offer a much more diversified source of income.

Exhibit 3: A global index – 77% of FTSE 100 companies' turnover derived from overseas sales as at November 2012



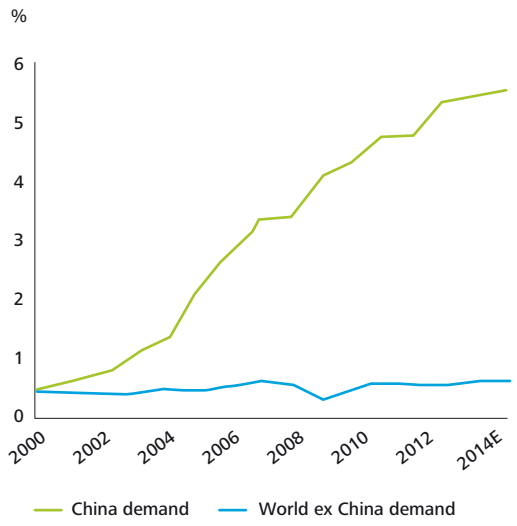

Source: Capita Group, November 2012. For illustrative purposes only.

Compared to more established economies, the value of investments in Emerging Markets may be subject to greater volatility due to differences in generally accepted accounting principles or from economic or political instability.

At Newton, being active means identifying drivers of change in the world – our 'themes'. Themes highlight areas for structural growth (growth which is not dependent on economic expansion). As an example, our *population dynamics and healthy* demand themes highlight a growing demand for pharmaceutical drugs as western populations age and disposable incomes in developing countries rise. In addition, the health care sector is experiencing greater success per dollar invested in research and development as companies are increasingly focused on just a few therapeutic areas. A wave of innovation in immuno-oncology drugs, which harness the human body's immune system, is promising to revolutionise the treatment of cancer. In late-stage trials the drugs appear to work across a broad spectrum of cancer types and the duration of response is much longer than for traditional chemotherapy. With structural growth, better capital discipline and a wave of innovation which will support drug pricing, we think the health care sector continues to look attractive as an investment. While valuations have moved up in the last couple of years, we believe the sector continues to look inexpensive relative to other defensive sectors.

Identifying structural headwinds is just as important as identifying areas for growth. When it comes to delivering a secure income, looking for companies where profits and hence dividends might be at risk of falling in the future is vital. One area which presents significant risks at the moment is the mining sector, where the last decade of demand growth has been driven primarily by China. As producers deliver significant growth in supply of metals such as iron ore, and the growth in Chinese demand has begun to moderate, the inflated prices of many metals have started to fall. The major mining companies have so far maintained their dividends. However, the structural changes in the Chinese economy lead us to believe that prices will not recover fully and that dividends will have to be lowered to a level consistent with the amount of cash generated by the companies.

Exhibit 4: Demand growth




Source: CLSA Asia-Pacific Markets, May 2014.
For illustrative purposes only

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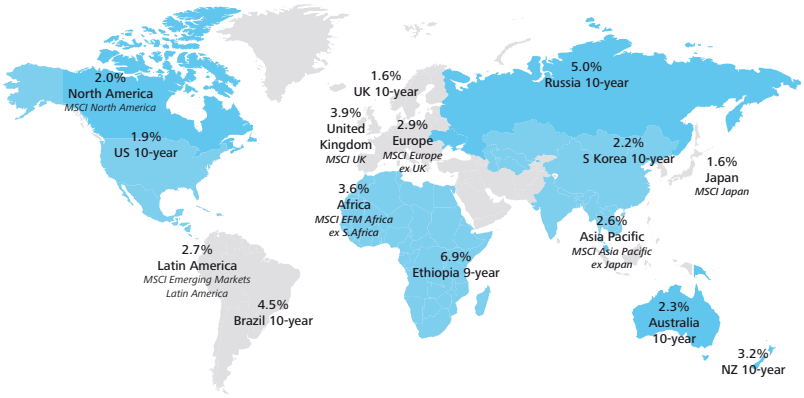
The current environment for income investors is undoubtedly a difficult one to navigate. Many charity investors have enjoyed significant gains in recent years, but financial markets now look more expensive, while risks in the global economy remain. In our view, the best solution is to maintain discipline and to be active, as this approach has longevity and allows investors to understand best the risks to their income and capital. Unfortunately there is no easy solution to generating income, and some charities may have to accept slightly lower levels of income, while others will need to adopt a total return approach. However, we believe both of these solutions offer better prospects for long-term capital preservation than reaching for yield.

Exhibit 5: World markets: gross equity dividend yields and 10-year bond yields




Source: Bloomberg, MSCI World as at 31 March 2015

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## VAT and temporary workers

The long-awaited Adecco case on the VAT treatment of temporary staff was heard by the First-tier Tax Tribunal in May. The case, taken by Deloitte, concerns a claim by Adecco of VAT over-accounted for on wages of non-employed temporary workers.

Charities often incur significant amounts of irrecoverable VAT on the cost of using temporary workers. Since the withdrawal of the Staff Hire Concession in April 2009, HMRC consider that VAT should be applied to the full amount charged for a temporary worker by an employment agency (i.e. the wages and national insurance contributions of the temporary worker, as well as the commission charged by the employment agency).

The Adecco litigation is intended to demonstrate that, in respect of non-employed temporary workers, employment agencies make supplies of introductory services only and that VAT should therefore be applied only to the commission element of the charge. A successful outcome would result in significant VAT savings for the charitable sector, both historically and going forward.

HMRC's view on the VAT treatment of temporary workers has already been challenged in the First-tier Tax Tribunal case of Reed Employment Ltd. Reed successfully argued that it acted as an intermediary between the temporary workers and its clients, simply making a supply of "introducing" workers to its clients in return for a commission. However HMRC did not appeal the relevant finding of the Tribunal and this meant that the decision did not set a binding precedent and had no wider impact on the sector.

Charities have therefore continued to incur VAT on employment agencies' commission, as well the salary and national insurance contributions. Deloitte has been working with the charity sector to take forward a new case to challenge HMRC's view on the VAT treatment of temporary workers and is delighted that the Adecco litigation presents a real prospect of HMRC's view on the VAT treatment of temporary staff being over-turned.

Deloitte is working with a large number of charities to review their position on temporary workers and help support the making of claims for overpaid VAT. For an initial discussion on the extent to which these developments can help your charity, please contact:

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## Newsflash – New audit thresholds

### Changes to audit thresholds for English and Welsh Charities

The audit exemption thresholds for English and Welsh charities has increased for periods ending on or after 31 March 2015 and this will broaden the number of charities where an independent examination can be carried out instead of an audit.

The gross income threshold for charities has increased to £1m and similarly group accounts are only required for these charities where gross income exceeds £1m. However, the asset threshold for audit exemption has not been changed and an audit will still be required if an English and Welsh charity's income exceeds £250,000 and its gross assets exceed £3.26m.

In addition the Charity Commission has updated its guidance Charity reporting and accounting – the essentials March 2015 (CC15c) [link to **https://www.gov.uk/government/publications/charity-reporting-and-accounting-the-essentials-march-2015-cc15c**]

to incorporate these changes. This guidance explains the different accounting and reporting requirements for different sizes and types of charity for financial years ending on or after 31 March 2015.

The audit threshold for charities registered in Scotland has not changed.

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