January 2020

Pulse – Deloitte's Charities and Not for Profit Group Newsletter

Welcome to the new edition of PULSE.

We have a packed edition to start you off in 2020! Some really interesting and topical issues appear in this edition. They cover, as usual, a range of topics that are affecting the sector.

Investment decisions, particularly in this volatile economy, are of real significance so the investment related issues are covered in here. There is a very interesting read on "cladding" as well as update on the requirements of the new section 172(1).

Thanks for 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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Burning Issues

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Charities' investment decisions are increasingly being influenced by issues such as climate and sustainability, as they start to see the financial benefits of engaging with companies on environmental, social and governance (ESG) factors. These are among the conclusions from the 2019 Newton Charity Investment Survey, which was conducted among leaders and decision-makers in the UK charity sector.

Shaping outcomes

Newton's surveys in recent years have consistently highlighted how a significant proportion of charities view ESG factors as important when considering the management of their investment portfolios. As topics such as climate change have risen up the agenda, the growing focus on environmental and sustainability issues has helped drive charities to support engagement with companies on ESG issues. However, this year's survey indicates that, for the first time, charities are starting to see the potential benefits of ESG engagement in terms of investment performance.

When we asked charities in 2018 about how ESG engagement influenced investment performance, 70% of respondents felt that ESG engagement did have an impact, but the majority (59%) thought that the impact was negative. However, in 2019, the perception of the effect of ESG engagement on investment performance has completely turned around. Nearly two-thirds (63%) of respondents feel that ESG engagement has an impact on investment performance – down 7% on 2018 – but of those 63%, 62% now feel that ESG engagement has a positive impact on investment performance, a 21% increase compared to the previous year.

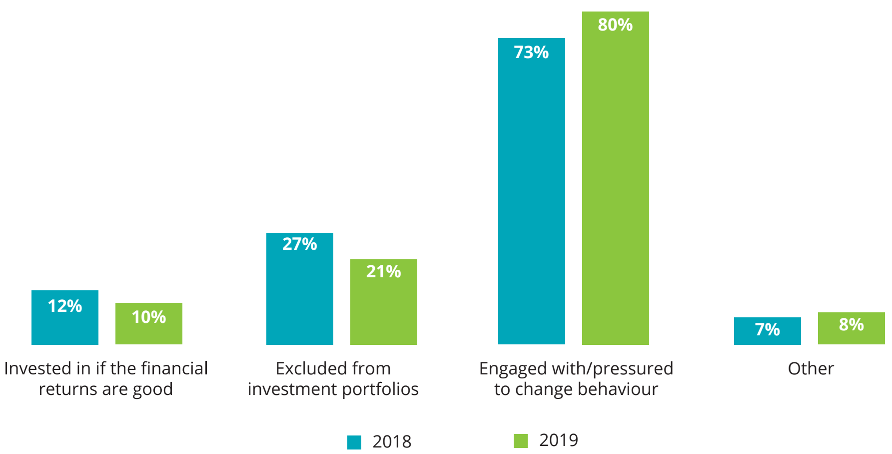
Furthermore, charities increasingly believe that it is better to engage with businesses to change their behaviour than to shut the door on them completely. The majority of respondents (80%) in our 2019 survey feel that when companies do score 'badly' on ESG criteria, they should be engaged with and pressurised to change rather than excluded from investment portfolios.

Climate change

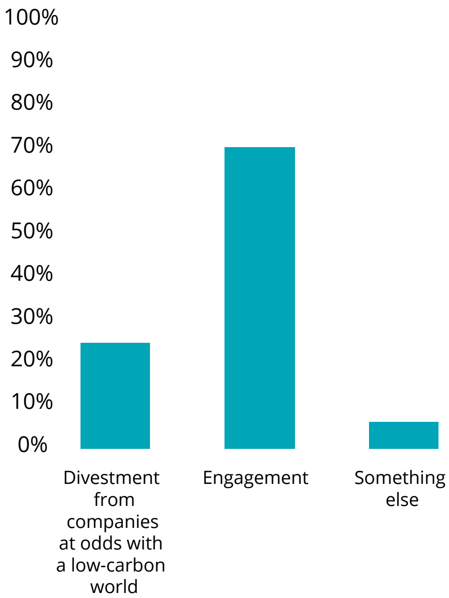
With climate change thrust into the media spotlight by the actions of Extinction Rebellion, Greta Thunberg and others in 2019, it is perhaps unsurprising that it presents a key concern for charities as they look to the management of their investments over the year ahead. Among the wider issues (unrelated to performance) mentioned most frequently among survey respondents, climate change trailed only ethics as a concern among charitable investors.

Whether the pressure to moderate investment choices is internal – through feelings of responsibility – or external – through pressure from stakeholders – charities once again appear to favour engagement as a method to ensure that climate-change factors are considered in the management of investment portfolios. 70% of respondents feel that engagement is the best approach, with only 24% stating

Companies that score 'badly' on ESG criteria should be...



Data set: No. of respondents: 2018: 97; 2019: 102



Data set: No. of respondents: 2019: 102

that 'divesting from companies whose activities are at odds with a low-carbon world' is preferable.

What is the best approach for ensuring climate-change factors are considered in the management of investment portfolios?

Moreover, 73% of respondents identified investing in companies with sustainable business practices as a form of sustainable investment, with 58% identifying investment in companies that contribute to sustainable development goals – goals which include 'affordable and clean energy' and 'climate action'.

Academic evidence

Charities' mounting conviction that pursuing a sustainable investment approach need not be detrimental to returns is backed up by academic research. In fact, a growing body of evidence suggests that, by focusing on actively engaging with companies on responsible and sustainable investment factors, returns may actually be enhanced.

Newton has been a long-term supporter of the Centre for Endowment Asset Management at the University of Cambridge's Judge Business School, which has provided valuable data to back up this assertion. The centre undertook an Active Ownership study[1], which examined examples of 2,152 engagement sequences at 613 US companies between 1999 and 2009. The rate of engagement success was 18%, and it required an average of two to three engagements before success was achieved. Typically, the time between initial engagement and success being recorded was 1.5 years. The 2,152 engagements were split into 1,252 environment and social sequences and 900 corporate governance sequences.

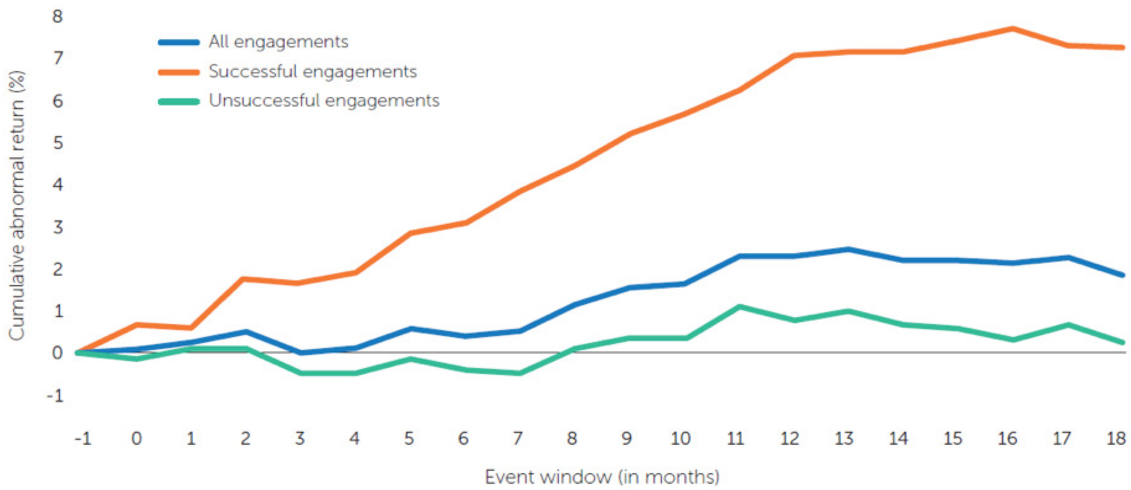
The results of the Active Ownership study revealed that successful ESG engagements can have a positive impact on returns, with very limited risk if an engagement is unsuccessful, illustrating the value of active engagement not just for society, but for firms and shareholders too. The chart below sets out the broad numbers, revealing that successful company engagements can lead to better returns over the longer term.

The value of active engagement

It is our belief that such engagement activity should form a key part of any sustainable investment strategy. Actively engaging with companies allows investors to monitor changes in management processes and remuneration, as well as social and environmental issues. By taking a proactive approach to engagement activity, it is possible to work with companies to increase the sustainability of their businesses over time.

The most direct form of engagement is taking an equity stake and voting.

Cumulative abnormal returns after engagement – 613 US companies 1999-2009[1]



[1] Source: Dimson, Li and Karakas (2015), Centre for Endowment Asset Management.
For illustrative purposes only.

To download the full version of the survey report, visit **newtonim.com/charitysurvey**

For further information please contact **stephanie.smith@newtonim.com**

Your capital may be at risk. 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.

However, we also believe that using human interaction to maintain a meaningful dialogue with a company is vital in helping to deliver better outcomes for shareholders, companies and society as a whole. In 2019, working alongside eight other investors, we co-filed a special climate change shareholder resolution asking BP to explain its thinking on climate change and how its business is aligned with the Paris Agreement on climate change. BP's board positively supported the proposal and the resolution was passed with a huge majority at the company's AGM in May. Other topics on which we have recently engaged with companies include palm oil, cobalt mining and gender diversity.

We believe that the demand for sustainable strategies will continue to grow as charities become increasingly aware of the need to make progress towards a more sustainable approach to investment. A forward-looking, active investment approach, which puts ESG factors at the forefront of decision-making, could help charities to achieve a dual outcome of investment returns and positive societal outcomes.

More about the Newton Charity Investment Survey

The Newton Charity Investment Survey covers diverse aspects of the management of charitable portfolios, and provides an industry benchmark to see how aligned charities' investment experience and intentions are with those of their peers. A total of 102 charities, with investment assets of almost £14 billion, responded to the 2019 survey, with fieldwork taking place between April and July. Our 2018 survey saw a total of 97 respondents, representing investment assets of £11.4 billion. For the majority of questions in the survey, six years' worth of data has now been collected, allowing for trend analysis, as well as an analysis of the impacts of political and social developments on investment performance and strategy over time.

Important information

Cladding – The Issue

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Since the Grenfell Fire the Ministry of Housing, Communities and Local Government (MHCLG) has issued 22 Advice Notes and has established the Building Safety Programme to cover high-rise residential buildings over 18 metres, including hotels and other assets with bed spaces, to make sure that residents of high rise buildings feel safe.

Advice Notes 14 & 21 were issued in December 18 and June 2019 respectively to provide guidance around cladding and fire safety issues. They give advice to building owners and their advisers on the fire safety of external wall systems for residential buildings >18m (approx. 5 or 6 storeys) in height. Questions are posed that are relatively straightforward in nature, but prove extremely difficult to answer. This is leading to problems particularly in selling and mortgaging properties – please see attached the front page from this week's Inside Housing.

What properties do the Advice Notes affect?

Any with a bed-space, i.e.

- private flats;
- affordable homes;
- student accommodation;
- hospitals; and
- care homes.

Organisations potentially impacted:

- Real estate funds, property companies;
- Other investors in real estate;
- Pension funds;
- Lenders;
- Universities;
- Public sector – local authorities, social housing providers;
- Charities;
- Student accommodation providers;
- Hoteliers;
- Care home operators;
- Construction companies; and
- Property management firms /FM out-sourcing /advisors.

Advice Notes 14 & 21

The Grenfell Tower fire has had a major impact on building and safety rules in the UK, particularly for high-rise residential structures. After focusing largely on Aluminium Composite Material ("ACM") cladding in the immediate aftermath of the tragic fire, the net was officially widened last year. In December 2018, the government published Advice Note 14, aimed at providing clear guidance for building owners and their advisors on what steps to take with regard to non-ACM materials on the external walls or balconies of their high-rise buildings.

While not a legal requirement, the note gives strong guidance to owners of buildings above 18m to take "general fire precautions" in their buildings and to make sure that external wall systems are "safe". The definition of 'safe' in the advice note is two-fold: (i) all materials must be safely installed and maintained (ii) the external wall systems (including cladding and insulation) must contain materials that are of limited combustibility or be a system that has achieved the Building Research Establishment's BR 135 classification.

To achieve this classification, systems will need to go through a BS 8414 test, something that very few materials being used have gone through. This means if the materials on a building are combustible and have not passed these specific tests, that property would be contravening the Advice Note and in need of remediation. The Advice Note also requires the building owner, or responsible person, to have an up-to-date fire risk assessment for their building.

It is becoming increasingly apparent that partly as a consequence of these Advice Notes that shared owners and leaseholders are now struggling to sell or re-mortgage their flats as surveyors and mortgage lenders require assurances that the materials on their buildings comply with the government's advice. Assurances that are extremely difficult to provide.

An RICS Working Group is to be commissioned in January to provide further guidance on this area.

What does this mean?

- valuers are using uncertainty clauses to highlight the potentially severe impact on liquidity in the current market for these assets; sales are still occurring, with the impact varying by sub-sector and the degree to which additional due diligence is available and being demanded by buyers or lenders. We know for example that on a student housing disposal the Vendor was required to provide sign off against the various Advice Notes – Advice Note 14 in particular before sale could conclude;
- There may be wider safety and reputational risks from a lack of action by Audit clients as regard cladding and fire safety; and additionally for collateral testing for lenders an awareness:
- That individual residential units within blocks may currently be potentially illiquid/unsellable due in part to the issues listed above and complicated by issues with regard to multiple ownership.

Questions for trustees and management:

- Have we undertaken a thorough review, to understand whether any assets might be impacted?
- Have any actions been undertaken to address fire safety and cladding issues in our buildings? e.g. Risk assessments, physical works, night time floor walkers
- How will any valuation uncertainty clause be reflected in the Financial Statements?
- Are there any wider Health & Safety concerns that should be reflected in the Financial Statements?

Questions for entities involved in construction:

- Has the entity used cladding on past/current projects?
- Has any of the projects come under review already?
- Have assurances been requested?

New section 172(1) reporting requirements for charitable companies

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The new requirement for the strategic report is set out in the Companies (Miscellaneous Reporting) Regulations 2018:

s414CZA(1) – Section 172(1) statement
A strategic report for a financial year of a company must include a statement which describes how the directors have had regard to the matters set out in section 172(1) (a) to (f) when performing their duty under section 172. Scope: all UK companies qualifying as large under the Companies Act 2006[2]

Section 172 – Duty to promote the success of the company

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole, and in doing so have regard (amongst other matters) to factors (a) to (f).

Have regard to

Section 172 matters

a. the likely consequences of any decision in the long term,
b. the interests of the company's employees,
c. the need to foster the company's business relationships with suppliers, customers and others,
d. the impact of the company's operations on the community and the environment,
e. the desirability of the company maintaining a reputation for high standards of business conduct, and
f. the need to act fairly as between members of the company.

[2] At September 2019, companies qualifying as large under the Companies Act 2006 meet at least 2 of the following criteria:

- Turnover of more than £36m
- Balance sheet total of more than £18m
- More than 250 employees

The requirements also apply to medium sized companies that are ineligible under section 467(1) of the Companies Act 2006.

Charity commission guidance ***information sheet 3*** issued in September 2019 makes clear that:

director's duties should be modified to be **promoting the success of the charity of achieve its charitable purposes.**

The charity's relationship with each stakeholder group will be different, the Section 172(1) Statement represents an opportunity to explain how the board gets comfortable that these relationships are managed effectively and that there is sufficient visibility of relevant stakeholder engagement activities in the boardroom to inform decision-making and delivery of strategy.

Charities may already have a stakeholder map, but if not, this can be a useful tool to identify key stakeholder relationships and to show the dependencies of each part of the organisation on different groups of stakeholders, and the impact that the charity has on each of those groups. Stakeholders can fall into two categories:

- those groups which are likely to be affected by the actions of the company; and
- those groups whose actions can affect the operation or business model of the company.

Charity stakeholders may include, but are not exclusively illustrated in the diagram.

What reporting could consider

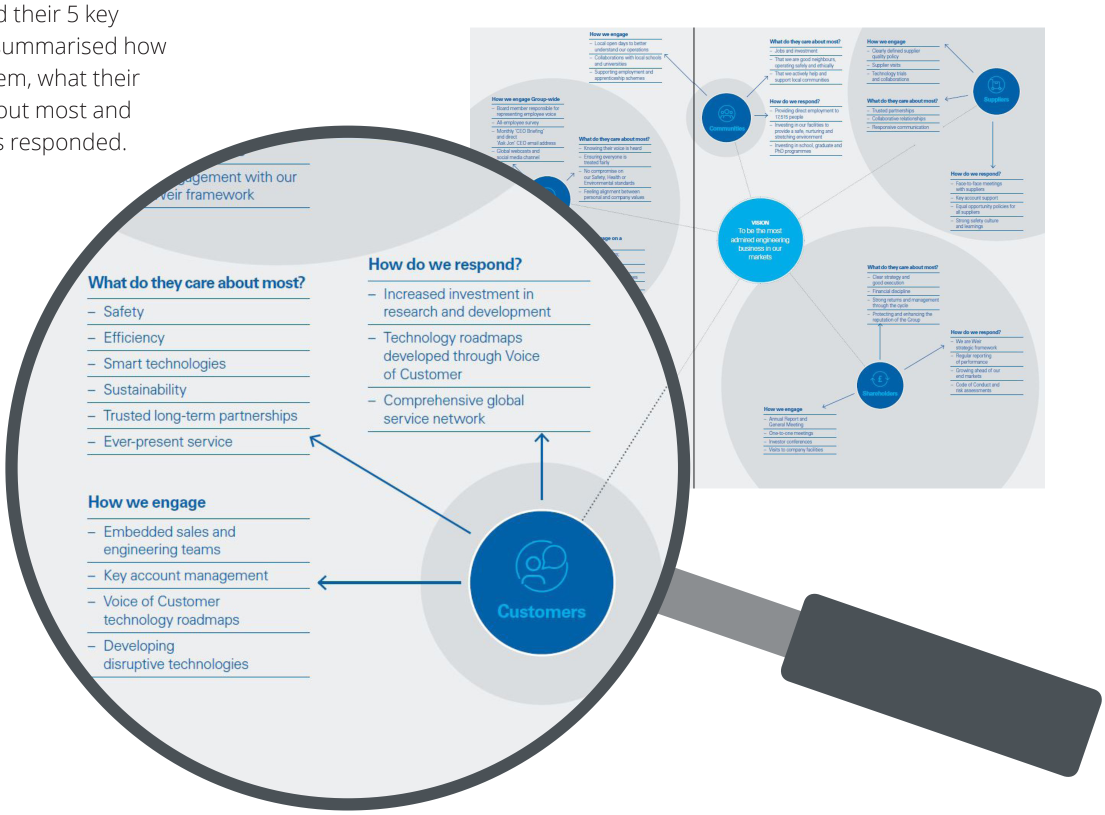
Although there are no charity examples yet of a section 172(1) statement and no full company statements , the Deloitte annual survey of FTSE reporting, ***Annual Reporting Insights***[4] , has identified some examples that trustees might find useful as a reference when preparing their annual report disclosures. The ones highlighted below include elements of demonstrating how input from stakeholders have influenced board decision-making.

However, they neither cover all the factors in section 172 nor all of the consideration points that may be used in developing the statement.

[3] http://www.charitysorp.org/media/647775/information-sheet-3-the-companies-misc-reporting-regs-2018.pdf

[4] https://www2.deloitte.com/uk/en/pages/audit/articles/annual-report-insights.html

Weir Group identified their 5 key stakeholder groups, summarised how they engaged with them, what their stakeholders care about most and how the company has responded.



Mears plc identified their six key stakeholder groups, summarised how they have engaged with each in the year and explained the relevance of this to their business model and strategy.

Listening to our stakeholders

Stakeholder engagement is central to our strategy. We are focused at delivering positive outcomes for all our stakeholders

Clients

How we engage
Our clients are from Central Government, Local Government, Housing Associations and the NHS. Our model has always been based on establishing long-term partnerships that address the significant challenges and opportunities faced by our clients. Transparency and responsibility are at the heart of our approach and we focus on solutions that establish sustainable solutions, rather than quick fixes.

Stakeholder expectations
The partners we work with expect a trusted partner that can contribute to strategic thinking as well as deliver excellent operational solutions that improve service and lower long-term cost. Increasingly partners are looking for good governance, a strong financial position and high levels of social responsibility.

Relevance to business model and strategy
We operate as trusted long-term partner to the public sector. As partners we have to demonstrate that our values complement their own. We are not like many other outsource organisations, in that both the focused nature of our services and the cultural fit with our clients continue to position us to win major new contracts, such as with the Home Office, and to retain long-standing contracts in the way that we do. We are also careful to not continue with contracts where values are not aligned, as demonstrated by us handing back some Care contracts in recent years.

Tenants and service users

How we engage
We have a long track record of listening to the needs of our end customers and having service solutions that address their needs effectively. Centrally, we have a national Change Club, made up of tenants from across the UK, who look at strategic service issues and support improvement. At a local level, every branch is charged with having a plan to engage with local people. This will be through regular tenant meetings as well as learning from the 80,000+ surveys that we carry out each year. We benchmark our engagement methodologies through Tpas and have long been a leader in this field.

Stakeholder expectations
Our tenants and service users expect to be part of developing solutions rather than to be simply a recipient. In Housing, expectations for engagement are rising, given issues identified post Grenfell and this is likely to lead to greater requirements going forward, which we will fully support. In Care, every service user has a personalised care plan, where each person directly contributes to the nature of their care.

Relevance to business model and strategy
As an organisation with a clear objective to be the leader in terms of customer service, wherever we operate, this cannot be done without good engagement. Our outstanding customer service performance is a testament to our success.

Communities

How we engage
In terms of community commitment, every branch is tasked with developing a social value plan for their area, which demonstrates where we will add value to the community, often over and above any contract commitments. This might be working with local schools to encourage and support young women, thinking of an apprenticeship, or working with local charities to support people who have become socially isolated. The detail of our work is shown in the Social value section of this report.

Stakeholder expectations
Stakeholders expect, given their long-term commitment, that we contribute positively to the communities in which they live. They want us to help local people into work, to upskill people and to work with them to address local issues where we can.

Relevance to business model and strategy
Being a socially responsible organisation with a firm commitment to supporting communities is essential to being a valued partner to our clients. Establishing strong community links also helps us attract the right people into our workforce and to establish links with other community-based organisations, which can contribute to our service offer.

Colleagues

How we engage
We are proud to be on the list of the Sunday Times 25 Best Big Companies to Work For. We have a national Workforce Group that is responsible for setting the approach to staff engagement and each local branch has a People plan, which sets out what it will do in each year. We have an Employee Director who sits on the Mears Group Board, which also helps ensure that the views of the workforce are listened to and actioned.

Stakeholder expectations
Our staff want to work for an organisation that values them and the communities in which they live. They want an organisation that treats people fairly and gives them the opportunity for personal development. Our staff really appreciate the fact that when they do a good job, they do help make a difference to society as a whole, given that better housing and care can make such a difference to the wellbeing of so many people.

Relevance to business model and strategy
Our workforce engagement is built around the Mears 'Red Thread' model, which works to establish the type and culture of workforce that we know will lead to both customer and financial success.

Suppliers

How we engage
We work in partnership with clients and we reflect this way of working with our suppliers. We focus on keeping our promises to them, be that how we pay them or the commitments we make in terms of helping them grow their business. We challenge them to operate to the same social value approaches that we do and have a clear supplier Charter that sets out our expectations from them. We recognise that all suppliers cannot be at the same level as ourselves but will support them where we can to improve. As you would expect, we set appropriate controls to ensure work quality and compliance standards are delivered to our expectations. We also have an established approach to setting up new supplier arrangements, to ensure that both parties are clear on responsibilities and risks.

Stakeholder expectations
The most important thing for our suppliers is that we keep the promises that we make to them. This means that we set out clearly what is expected in conjunction with our supply partners and that we keep our part of the arrangement in a fair and transparent way.

Relevance to business model and strategy
Our supply chain is fundamental to the success of our business, both in the provision of materials and in the delivery of services under our leadership.

Investors and bankers

How we engage
The Company is committed to maintaining good communications with investors. There is an active programme of communication with existing and potential shareholders. There is increased dialogue with institutional investors following the publication of final and interim results, which is facilitated through a series of formal presentations. The Company has also looked to hold additional investor days during the year to ensure that they are better informed of market and Company developments. The Group regularly receives and responds to questions raised by small private shareholders through the investor enquiry portal within the Group's website. The Group holds regular meetings with its funding partners.

Stakeholder expectations
Our shareholders and bankers expect the Group to maintain a high standard of corporate governance. Mears recently achieved a very high rating from FTSE4Good, which assesses listed company policies and procedures on social impact, environmental impact and governance. Our shareholders require Mears to deliver sustainable profitable growth, with good generation of free cash flow and dividend growth.

Relevance to business model and strategy
Our funders are fundamental to the Group's success. Mears has utilised equity to complete a number of acquisitions, most recently MPS, ILS and Morrison. The Group's organic growth strategy has been funded through both debt and retained earnings, none of which could have been delivered without shareholder and banker support.

24 Mears Group PLC Annual Report and Accounts 2018

Mears Group PLC Annual Report and Accounts 2018 25

The **National Grid** provided two perspectives on engagement in their report: Firstly, in their discussion of matters considered by the board they summarised the

- key areas of activity;
- the matters considered;
- the outcome; and
- the views of key stakeholder groups considered; and

secondly, in their 'creation of value' discussion they have tabulated each stakeholder group, the form of engagement and how that stakeholder group influenced the board agenda and decision-making.

Drafting the statement

For some charities this new reporting requirement may not entail significant changes. However, others may have to enhance policies and practices or introduce new ones. For example most charities will already engage with employees, beneficiaries, volunteers and other stakeholders, but the links between the engagement and decision-making may not have been that clear.

The Charity Commission guidance states that the statement may be included as part of the content contained under the heading 'achievements and performance' in the report; under the heading 'strategic report' where the trustees' annual report has been adapted to provide the required contents of the strategic report[5].

Publishing the statement

The statement must be published on the Charity's own website, for most large charities the full annual report is already available through the charity's website, so this will not entail any change in approach. However, for the avoidance of doubt, the Charity Commission guidance states that making the annual report available through the Charity Commission website is not sufficient to fulfil the requirement and that charitable companies must publish on their own website the statement itself; the whole strategic report; or the complete annual report[6].

Next steps

The challenge for trustees will be to weave the information already available, and any new practices, into a statement that reflects both the complexity of decision-making and the thoughtfulness of charity trustees as they balance sometimes conflicting interested in the exercise of their duties.

More detail of the statement and considerations of questions that may be asked for each stakeholder group can be found in our **Board briefing on section 172 statement**[7] which considers the impact for all large private companies.

More detail of all the new reporting requirements applicable for periods commencing on or after 1 January 2019 and the new energy and carbon reporting requirements applicable for periods commencing on or after 1 April 2019 can be found in our Charities Alert on Changes to Reporting.

Section 172 factor	Example of relevant existing disclosure
The long-term	• Charity purpose and objectives • Strategy • Activities
Employees	• Talent • Diversity & Inclusion • Employee engagement • Volunteer engagement
Business relationships – suppliers, customers	• Anti-bribery and anti-corruption disclosures (if made) • Modern Slavery statement (where included in the annual report)
Community and environment	• Public benefit • Community & environment aspects of activities (if included)
High standards of business conduct	• Culture • Ethics and values • Corporate governance statement

[5] Information sheet 3 – 4.19: SORP (2019) 15.8.

[6] Information sheet 3 – 4.20

[7] https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-board-briefing-on-s172-statement.pdf

Updated SORP and New Guidance released

The Charity Commission has published the Charities SORP (FRS 102) - the second edition and two new Information Sheets.

The joint SORP-making body for charities, in partnership with CIPFA, has published a second edition of the SORP. For reporting periods starting on or after 1 January 2019, all charities must follow the Charities SORP (FRS 102) - second edition that applies the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS 102). Two new Information Sheets on reporting by medium and large UK charitable companies and defined benefit pension accounting have also been published. Copies of all these documents are available at http://www.charitysorp.org/.

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