



Pulse – A newsletter for Charities and Not for Profit Organisations

Welcome to the new edition of Pulse. 2020 has been a year of changes for us all as we have adapted to new restrictions and ways of working. We muse in this edition on the challenges faced by charities in managing investment income and in providing support for subsidiaries. We consider the streamlined energy and carbon reporting requirement and include some thoughts for reviewing or compiling a section 172 statement and integrating the impact of COVID-19 with risk and other narrative reporting.

We also take this opportunity to say goodbye to Reza Motazedi who has led our Charities and Not for Profit group for a number of years and wish him well in his retirement. We welcome our new group head Jonathan Gooding and partners Craig Wisdom and Nicola Wright.

Thank you for reading from the Charities and Not for Profit Group

COVID-19: The income challenge



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In the wake of economic fallout from COVID-19 challenges we examine the outlook for dividend payments and explore how charities can seek to navigate the uncertain backdrop

Charities have faced income challenges in the past and will do so again. Recessions and economic slowdowns have generally offered alternative channels for income investors to navigate, and it has been possible to estimate and plan for the impact on income streams. The current challenges are unique in their nature; before even considering their investment income, many trustee bodies have been dealing with brutal temporary reductions in income from trading subsidiaries, fundraising events and the like. While very recent vaccine news is more optimistic, prospects for a return to normality remain highly uncertain.

In terms of investment income, the near-total economic lockdown of the Spring had a devastating impact on revenues for multiple sectors, creating an undeniably challenging outlook. Dividends from oil companies have been cut or appear under threat, while banks in many areas are still asked by regulators not to pay. A number of consumer-facing and industrial companies which are facing unprecedented falls in their revenue have moved to suspend or postpone their dividends. While for some it has been a financial necessity to ensure sufficient cash for their operations, others are acting cautiously as they consider worst-case scenarios, or because they see it as important that all stakeholders share the pain while they receive government help. Income from property investments is as uncertain, and government bond yields have been driven to negligible levels. There are brighter spots. We would expect fixed-income coupons to continue largely uninterrupted, and some sectors

(pharmaceuticals, some consumer stocks, and the technology and 'online' winners) remain in good dividend-paying health (although the technology sector tends to be quite low-yielding in the first instance.) Some companies are returning to dividend paying already, but in many cases will – out of prudence or choice – reset to lower levels.

Trustees should by now have a good grasp of the extent of their near-term investment income challenges, but how long will these last? How quickly will companies return to dividend paying? Will they resume paying at historic levels? Or reset to lower distributions? Vaccine developments offer more hope, but the road to opening up global economic connections as well as local ones still looks to be a long one. Looking through that, it appears more likely to us that these cuts are perhaps starting to take on more of a 'structural' rather than temporary hue in some areas. Clearly the detriment will vary portfolio by portfolio, but we think that income reductions of around 30% for the calendar year 2020 will prove quite typical from a balanced portfolio; visibility is improving for 2021 and we are expecting muted recovery from that lower level.

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.

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How should we react?

In these difficult times, we are committed to doing what we believe is best for the long-term returns of charity investors. The current circumstances are naturally leading us to stress-test the companies in which we invest, but where they come through that process with our conviction unchanged, our first response will be to look through the temporary disruption to dividends to more normal times when dividends are resumed, and retain what we feel are good investments. This will suit many, but we recognise that what is best for each charity can be different. It is possible that some charities will require their portfolios to be managed with an emphasis on limiting the near-term income detriment. Others may be able to use capital to supplement income, or indeed may have some flexibility in their business through an income reserve, or the ability to defer some of their own expenditure.

A charity's investment portfolio is, first and foremost, an integral part of the charity's business, and needs to be configured appropriately to that end. The clarity that we are now seeing suggests continued challenges to investment income, and in many cases portfolios are being reviewed in light of that expectation. As the remainder of 2020 and the early months of 2021 unfold, and information around the likely path to societal normality and therefore economic recovery becomes clearer, we will be working closely with investing trustees to plot the most appropriate course ahead.



Financial stability of charity trading subsidiaries



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The economic and operational challenges of 2020 have left few organisations unaffected and the impact on charities can sometimes arise from more than one front. Alongside a reduction in individual donations and income derived from charitable activities, many are finding that the activity of their trading subsidiaries has been severely curtailed and hence the income flows from subsidiary donations are also reduced.

Consequently, in addition to managing the impact on its own finances, charity Trustees may also be finding the financial viability of their trading subsidiaries is being challenged. This leads to questions around whether the parent charity can provide financial support for its subsidiary. In a traditional commercial group scenario the parent might simply make an assessment of the subsidiary's future financial prospects and act accordingly. For charities the situation is more nuanced due to a number of issues that will need to be carefully considered by charity trustees and their advisors to mitigate the risk of corporation tax¹ costs arising.

General governance principles

Trading subsidiaries are generally (but not exclusively) funded by their parent charities. However the parent charity needs to be able to demonstrate that this is justifiable use of the charity's funds. Further comment on this aspect is set out below under 'Qualifying loans and investments'. Specifically charities should not be providing any type of support that could be viewed as a gift e.g. purchasing stock for the subsidiary, donating goods/ services to the subsidiary, allowing use of buildings, equipment, staff etc. at reduced rates, settling the debts of the subsidiary.

When a subsidiary is in financial difficulty Trustees may feel a moral obligation to support the subsidiary and may also be concerned about the reputational risks of having an insolvent or liquidated

subsidiary. However Charity Commission guidance is clear in underlining the risk that if a parent charity maintains a failing subsidiary at its own expense, the Trustees may be personally liable for any losses to the charity.

That is not to say that support cannot be given but thorough diligence should be undertaken to assess the future viability of the subsidiary, its ability to repay any funding provided and its capacity for future contribution to the charity as part of an assessment of whether the provision of support could be justified.

Qualifying loans and investments

Where a charity makes a loan or investment of any kind it should, from a governance perspective, be a justifiable use of the charity's assets. This is translated into tax terms in the concepts of qualifying loans and investments which are defined as follow:

- any investment in a charity common investment fund, common deposit fund or similar scheme
- any interest in land (unless it is held as a security or a guarantee for a debt)
- shares or securities of companies listed on a recognised stock exchange
- units, etc. in a Unit Trust Scheme
- shares in an Open-Ended Investment Company
- bank deposits - other than deposits made as part of an arrangement under which the bank makes a loan to somebody else (e.g. back to back loans)
- certificates of deposit
- a loan made to another charity for charitable purposes only
- a loan to a beneficiary of the charity, and made in the course of carrying out the purposes of the charity

¹References are to corporation tax which applies to charitable companies and other entities deemed to be companies for tax purposes (e.g. universities, unincorporated associations). The same principles would apply to charitable trusts which are subject to income tax rather than corporation tax.

- money placed in a current account at a bank (other than as part of an arrangement under which a loan is made by a bank to some other person)
- any loan or other investment made for the benefit of the charity and not for the avoidance of tax (whether by the charity or any other person)

Financial support given to a subsidiary inevitably falls into this final category which, whilst appearing to be widely drawn, also requires a more robust approach to evidencing the decisions that have been made.

If an advance of monies was found to be a non-qualifying investment or loan then the charity would potentially incur a tax charge on the amount advanced.

Debt rationalisation

Rather than advance cash, a charity may look to improve the solvency of the subsidiary's balance sheet by releasing intercompany debt balances or undertaking a debt to equity swap. In addition to considering the complex tax treatment of debt and similar instruments, two of the key themes are once again brought into the spotlight:

- Debt for equity swap - if a charity decides to convert repayable debt to less secure share capital, is this an investment decision? If so, is it a qualifying investment?
- Writing off intercompany balances - is there a debit to the Income Statement that could be classed as expenditure? If so, is there a risk that HMRC would seek to classify it as non-charitable expenditure, regardless of the circumstances in which the balance arose?

There are no hard and fast answers here, no checkbox to simply work through and HMRC would assess each case on its own facts and merits.

Gift aid donations to the parent charity

The majority of trading subsidiaries do not carry significant reserves. In order to maximise the tax efficiency of the trading company structure, subsidiaries repatriate their profits to their parent charity via a donation which minimises the taxable profits that arise in the subsidiary and hence the corporation tax cost to the whole group.

However, in order to be effective for tax purposes, the donation of 100% subsidiaries needs to be paid in cash to the parent charity within 9 months of the subsidiary's year end. Furthermore the donation can only be made if there are sufficient distributable reserves.

If a subsidiary has taken on debt, it will at some point need to use cash to make loan principal repayments. This will reduce the level of cash available to make a donation to the parent. In turn, taxable profits and therefore the corporation tax cost to the group could be higher. This will be an issue whether the loan comes from the parent charity or if the subsidiary has sought debt funding from other sources including government backed loans.

Although not necessarily related to the question of parent funding, the availability of distributable reserves may also present challenges to the ability to make a donation. As donations to parent charities are deemed to be distributions, the subsidiary needs to have sufficient distributable reserves to fund the donation at the point the donation is made. Many subsidiaries with year ends of October 2019 onwards may not yet have paid the donation in relation to their 2019 accounting period. However a downturn in trade may mean that, for the year to date, they are loss making and therefore do not have sufficient distributable reserves to make the donation, which will lead to a corporation tax liability for the prior period. There may be scope to mitigate the impact of this through a carry back of trading

losses from the subsequent period but the cashflow pressure of needing to pay the corporation tax liability in the interim would remain.

Closing remarks

The key driver for the decision on providing financial support will be a commercial one that considers the future prospects of the subsidiary and whether or not providing the support represents good use of the charity's money/assets, etc. However, as we have seen, there could be tax cost implications of the decision which Trustees need to be aware of and factor into their overall assessments.

If you would like advice on your own particular circumstances, please contact Rhys Cartledge (rcartledge@deloitte.co.uk) Tel: +44 121 695 5122 or Caroline Jackson (carjackson@deloitte.co.uk) Tel: +44 191 202 5287).

New reporting challenges for charitable companies



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Guidance issued by the Charity Commission SORP Committee in March 2020

2020 has been a challenging year for everyone, including charities, and as the year draws to a close and accounts are prepared, now is the time for charities to tell their story.

Whilst all charities will reflect upon the impact of COVID-19 on their operations and results, for large charitable companies there are two further challenges:

- To present a (second) section 172 statement²
- To report against the Streamlined Energy and Carbon Reporting (SECR) requirements³

The Charity Commission and the Financial Reporting Lab of the Financial Reporting Council (FRC) have both published advice to help charities and charitable companies meet all these requirements.

COVID-19 impact and charity plans

The SORP Committee has already issued guidance on the key matters that trustees may wish to consider in their annual reports. These included explaining how the financial and operational effects of the virus and the control measures relating to the virus affected, among other areas:

- activities;
- the principal risks and uncertainties facing the charity during the reporting period;
- staff, volunteers and beneficiaries; and
- reserves and going concern.

In October 2020, the Financial Reporting Lab issued two short guides which updated its earlier work (COVID-19 – Resources, action, the future and COVID 19 – Going concern, risk, and viability) with some more recent thoughts and examples⁴. The report raises

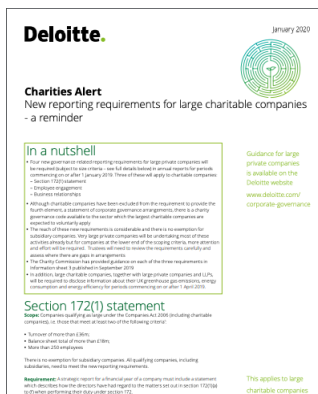
two main criticisms/suggestions. Firstly that 'best case' and 'realistic worst case' scenarios are often reported with only generic information about assumptions being provided; and secondly that reporting the impact of COVID-19 on other risks may provide more useful information to the users of the trustees' annual report. The report highlighted a good example of going concern reporting where the going concern scenarios were linked to the risks and the plans for the future, and noted a useful example where the impact of COVID-19 on the risk rating was disclosed, making it clear which areas of the business and its activities were most affected by the pandemic.

Both these examples highlight the fact that for good reporting, it is important for trustees to avoid generic phrases and explanations that, it is 'due to the pandemic' but be specific about the impact, circumstances, activities and risks

²Required for all large charitable companies with year ends beginning on or after 1 January 2019

³Required for all large charitable companies with year ends beginning on or after 1 April 2019

⁴the Financial Reporting Lab report [Going concern, risk and viability - COVID-19 and Reporting in times of uncertainty - a look forward](#) and [Resources, action, the future - COVID-19 and Reporting in times of uncertainty - a look forward](#) - be found on [FRC website](#).



In January we published a briefing on the new requirements which can be found on our [website](#).

Section 172 Statement

The section 172 statement should not merely be a compliance exercise but instead should reflect how the company met the requirements, should explain what is relevant to it and what happened during the year and, where applicable, what the board and management plan to do in the future. (Financial Reporting Lab October 2020)

In October 2020 the Financial Reporting Lab published a list of tips intended to help companies consider what content to include in a section 172 statement, how to present it and how to facilitate the process of preparing the statement. These tips are structured under three headings and provide useful considerations for charity trustees when reviewing their first or second section 172 statement.

Building in useful content - Trustees should ensure that a reader can understand:

- Why particular stakeholders are identified
- What engagement methods were effective (for different stakeholders)
- The link to strategy.
- The difficulties not just positives.
- How the board challenges and oversees engagement with stakeholders and stakeholder management.
- Material KPIs on the key stakeholders.
- The implications of the stakeholder feedback received, the impact of decisions on relevant stakeholders, and what actions have been taken or are planned as a result.
- It is important that the statement and examples are consistent with the rest of the trustees' annual report.

Presented in a way that makes sense - the Section 172 statement should:

- Be positioned so that information logically flows with other information presented in the strategic report, or strategic report section within the trustees' annual report.
- Be clearly labelled and referred to in the contents pages of the trustees' annual report.
- Make use of cross referencing, where appropriate, to expand upon points made in the statement and provide further context. However, this should not just be a list of links and the statement should still provide a coherent message by itself.
- Include examples and case-studies of significant strategic decisions taken during the year, explaining how stakeholders were taken into account to bring the statement to life.

Supported by process - charities should:

- Consider tailoring board agendas, papers and minutes to include reminders for both the board and management to consider which stakeholders are relevant for decisions.
- As trustees review their reports these expectations provide a helpful checklist for this year's reporting and the process going forward.



Guidance issued by the Charity Commission SORP Committee in June updated September 2020

Streamlined Carbon and Energy Reporting requirements and climate change

The Charity Commission SORP Committee published Information Sheet 5: The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018, as applied to Charitable Companies - update in September 2020. This publication sets out the requirements and clarifies that for charities preparing group accounts under the 2018 regulations (Regulation 20D(5)) permits the exclusion of the reporting of emissions and energy consumption outside the UK. The Regulations broaden the greenhouse gas reporting requirements for quoted companies and extend the reporting requirement to all large companies and LLPs. Additional information on energy consumption, including at least one intensity ratio, and any steps taken to increase a company's energy efficiency is also required.

However, the challenge for charities will be, as with the pandemic, not to view these as an isolated reporting requirement. The section 172 statement demands that trustees consider the impact of the charity on its environment. Both the energy use reporting and the consideration of the environment under section 172 reporting should be consistent and reflect any risks to the charity and any future plans it has identified in relation to climate change and its environment. One of the key outcomes of the Financial Reporting Lab's climate thematic review is that whilst legal requirements are often being met any intentions or aspirations are not always clearly linked to strategy and objectives.

Therefore as charities tackle the new reporting requirements, trustees may wish to consider how they are able to assess both the potential impact on the development, performance and position of the charity of climate change and the

charity's impact on its environment. For example, the carbon footprint of activities, infrastructure, travel policies, waste management and water usage, as well as the information and expertise available to the Board.

Types of climate change risk

The Taskforce on Climate related Financial Disclosures (TCFD) recommendations divide climate change risks into two categories: physical risks and transition risks. These risks provide a useful starting point for trustees when considering their own activities.

There is further guidance on climate change and the impact on narrative reporting in our publication A closer look | climate change.

Physical risks

Physical risks are associated with disruption to business activities from climate change. Physical risks can be acute, one-off disruptions such as from extreme weather events and they can also be chronic – gradual changes that have a more lasting impact e.g. due to changing rain patterns, rising mean temperatures and sea levels, or prolonged periods of heat or drought.

Impacts from climate change-related events can be widespread across a charity's operations, with significant financial consequences. Climate change can affect a business's facilities, operations, supply and distribution chains, employees and beneficiaries.

Risks to charities include:

- Reduced revenue as changes in the economic environment mean less disposable income
- Increased operating costs arising from supply chain interruptions or impact on the workforce.

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