

# Charities and insolvency

Guidance note for the Charity Finance Group (CFG) and the  
Association of Chief Executives of Voluntary Organisations  
(ACEVO)

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## Contents

Summary of key points .....	3
What is insolvency? .....	3
The balance sheet test and its limitations .....	3
The cash flow test.....	4
Funds of a charity .....	5
The position of trust funds.....	6
Requirements to set up a trust (restricted funds) .....	7
Liquidation of charities .....	7
The position of trustees and directors .....	8
Fraudulent trading.....	9
Wrongful trading.....	9
Preferential transactions .....	9
Mitigating circumstances.....	10
Disqualification of directors.....	10
Going Concern .....	10
A stitch in time.....	11
In conclusion .....	13
Appendix 1 – Relevant extracts from the Insolvency Act 1986 .....	14

On 28 March 2020 the government announced changes to the insolvency regime aimed to provide companies breathing space and keep trading through the COVID-19 pandemic. There will be a temporary suspension of wrongful trading provisions to remove the threat of personal liability during the pandemic, applied retrospectively from 1 March 2020. In addition, there was a temporary moratorium for companies undergoing a restructuring process so that they cannot be put into administration by creditors and will continue to be able to pay suppliers and staff.

It has been clarified that these measures do not impact the existing laws relating to matters such as fraudulent trading, transactions defrauding creditors, misfeasance.

The temporary measures have now expired. However there are additional permanent measures that have been brought in by Corporate Insolvency and Governance Act 2020. More information can be found at <https://commonslibrary.parliament.uk/research-briefings/cbp-8971/>

## Summary of key points

- There are normally two tests of insolvency – the balance sheet test (positive net assets) and the cashflow test.
- The key issue is can the organisation pay its debts as they fall due.
- Careful consideration is required of many factors such as what values can be realised in time to meet debts and what assets can be used to meet liabilities.
- Understanding is needed of the implications of the different restricted and endowed funds held by the charity.
- The position for trustees of an unincorporated charity is different and the risks are usually higher.
- Directors and shadow directors can be guilty of wrongful trading if they continue to trade and incur liabilities they knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation.
- Fraudulent trading is also a risk.
- The charity should avoid entering into preferential transactions which put another party in a better position to the detriment of other creditors.
- The court will recognise mitigating circumstances. For example, if the directors took proper steps to minimise the potential loss to the company's creditors.
- The Companies Act requires that the accounts are prepared on a going concern basis unless there is a reason to believe that this is not appropriate. Therefore, Directors must consider whether the entity is a 'Going Concern'.
- 'Cash is king'. Organisations should ensure that they focus on careful cash management and recognise that some funds are not available for general use or to pay creditors.
- Good management information is vital and it is important to reassess how the charity identifies what matters, recording and reporting on what matters.
- Knee jerk reactions are risky and careful consideration of reserves and how they can be used coupled with cost optimisation and a real focus on income can help manage the situation.

- It is important to look beyond the obvious and to recognise that the impact on income generation may be delayed but reduction in income can be sudden with little warning and therefore good communication and careful evaluation and forecasting are needed.
- There should be action plans for different scenarios and monitoring of trigger points and trend analyses to enable the charity to decide when it needs to put the plans into place.
- All decisions must be carefully made and the deliberations should be properly recorded.
- The frequency of Board meetings and briefings from management may need to increase and it is vital to show that the Board received proper and up to date information to really evaluate the financial position.

Difficult market conditions mean that a number of charitable organisations want to understand the rules of insolvency and how this impacts on the responsibilities of the Board and management. A number of Finance Directors, Chief Executives and Trustees have asked about issues such as negative balance sheets arising from falls in asset values, about the possible use of restricted funds and the impact of uncertainties with income generation.

There is clearly concern and a desire to understand the law and regulatory perspective. This guidance note covers many important issues and technical matters so brevity has lost out! It outlines relevant issues but individual circumstances will need to be considered and charities should seek professional advice if they have any concerns about insolvency.

The *Insolvency Act 1986 as amended by the Insolvency Act 2000 and the Enterprise Act 2002 (the Act)* contains the basic legislation and I have copied relevant sections in the Appendix to this guidance note. The Act applies to charitable companies but in their publication – ‘*Managing Financial Difficulties and Insolvency in Charities*’ (CC12)<sup>1</sup> the Charity Commission states “We recommend that, as a matter of good practice, a similar approach is adopted for unincorporated charities”.

## What is insolvency?

It is usually held that a company is insolvent if it is unable to pay its debts. This view is supported by the Association of Business Recovery Professionals; they state that “a company is insolvent if it is unable to pay its debts when they fall due [or] the value of assets is less than the liabilities”.

There are two main tests, which can be used to determine the solvency of a charity:

- **The cashflow test.** The basis of this test is whether the charity can pay its debts as they fall due (*Section 123 of the Insolvency Act 1986 – see appendix*). The test is applied in the following two cases:
  - a) where the directors wish to carry out a solvent winding up they would have to state whether the charity will be able to pay its debts in full plus interest within a period not exceeding 12 months from commencement of the winding up
  - b) *section 122(1) (f) of the Insolvency Act 1986* provides that the Court may wind up any company that is unable to pay its debts.
- **The balance sheet test.** The basis of this test is whether there is an actual or anticipated deficiency of assets over liabilities. A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. Paragraph b) above applies in this case also.

## The balance sheet test and its limitations

Due to the application of particular accounting principles and standards the balance sheet test often does not provide sufficient information about the true position of a charity. For example, tangible fixed assets are usually stated at cost but this may have little relevance to their market value.

Also, a pension scheme deficit calculated on the basis of accounting standards may lead to a negative balance sheet but will not, of itself, impact on the cash flows of the sponsoring charity into a defined benefit pension scheme. The cash contributions required by the employer are arrived at through negotiations with trustees and / or through statutory requirements, either of which may involve measuring surpluses or deficits on a different basis to that required by accounting standards

<sup>1</sup> <https://www.gov.uk/government/publications/managing-financial-difficulties-insolvency-in-charities-cc12>

In this regards the Charity Commission has said, “Where, under FRS102, a charity discloses a significant pension fund deficit, this does not mean that an immediate liability for this amount crystallises. Similarly, where a pension surplus is disclosed this does not create an immediately realisable asset that can be released straight away and expended on the purposes of the charity. In particular, the disclosure of a pension liability does not mean that the equivalent amount is already committed and is no longer available to the trustees to further the charity’s objectives”.

Also, charities follow different income and expenditure recognition policies and this will have an impact on the balance sheet. For example, some charities may recognise as a debtor future grant income whilst others may not and some recognise future grant commitments whilst other do not.

Therefore, the cashflow test is seen to be more relevant than the balance sheet test as it attempts to quantify the market worth of assets and when they can be realised and how they can be used.

A balance sheet can be viewed on a going concern basis (see section on Going Concern) or on a break up basis. On a break up basis there may be more liabilities that crystallise and the valuation of the assets as well as potential repayments to funders or creditors becomes critical. When financial statements are prepared on a going concern basis tangible fixed assets such property and equipment are usually represented in the balance sheet at their historic cost less depreciation. This is not usually the value that should be taken into account when considering solvency. The value should be the market value of a forced sale and in the case of a special purpose asset it is highly likely that this value may be substantially below the book value. This is because accounting principles recognise the concept of value to a charity and there is often no need to write down a tangible fixed asset if the value in use is higher than the book value.

A charity may face the spectre of insolvency even when it has a positive balance sheet. For example, its debtors may be slow in paying, its assets may be difficult to crystallise or may not be easily available to meet debts as they fall due. Similarly a balance sheet may appear to show a deficiency of assets over liabilities but the charity may still be solvent if the timing of cashflows means that it can ensure it can meet its liabilities and debts as they fall due.

*Totty & Moss*, in considering ‘inability to pay debts’, states that: “It is not clear on what basis the court is supposed to value either a company’s assets or its contingent and prospective liabilities. It is considered that the value of the assets should be based on estimates of the figures that would be realised in a liquidation; and contingent and prospective liabilities should be valued at the sum for which they would be admissible if a winding-up order was made. The only assets and liabilities to be taken into account are those which flow from contracts entered into and things done by the company up to the time the assessment of ability to pay debts is being made.”

It is also important to consider liabilities not on the balance sheet such as future commitments and contingencies, which ought to be taken into consideration. For example, any repayments on grants received or costs arising from unfulfilled service contracts. There may also be new liabilities that crystallise on liquidation, such as staff redundancy costs, outstanding lease and dilapidations payments, costs incurred in realising assets and professional charges. Charities that operate internationally will have to bear in mind local costs that may crystallise as well as the impact of foreign exchange rates and the ability to repatriate funds or transfer funds from one country to another.

## **The cash flow test**

Prima facie it may appear that this is a simple test – either the charity is paying its debts or it is not. However the matters to be considered are more complex. *S123 (1) (e)* provides that a company is deemed unable to pay its debts “if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due”.

This section was considered for the first time in a legal decision relating to Cheyne Finance Plc, one of the early casualties of the 'credit crunch'. The analysis is that technical insolvency may be triggered earlier in some cases than might have been expected and that the circumstances may be particularly relevant to charities.

In the decision of *Re Cheyne Finance Plc (in receivership)* [2007], Mr. Justice Briggs considered the level of consideration that should be given to debts falling due in the future and the timing of the cashflows and the ability to use funds to pay certain debts.

In fact the case appears to extend the cashflow test to one where consideration has to be given to not just whether a company is unable to pay its debts but also whether it is likely to become unable to pay its debts. This then begs the question as to how far forward one has to look. Justice Briggs stated, "cashflow or commercial insolvency is not to be ascertained by a slavish focus only on debts due as at the relevant date. Such a blinkered review will, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases fail to see that due to an endemic shortage of working capital a company is on any commercial view insolvent, even though it may continue to pay its debts for the next few days, weeks or even months before an inevitable failure".

The court clarified that the availability and use of assets needed to be considered. So a company may have positive net assets but they may not be easily realisable in a way that it could meet its debts. The judge gave the following example: "The company has £1,000 ready cash and a very valuable but very illiquid asset worth £250,000 which cannot be sold for two years. It has present debts of £500, but a future debt of £100,000 due in six months. On any commercial view the company clearly cannot pay its debts as they fall due, but it is, or would be balance sheet solvent".

This is particularly relevant for a charity which has restrictions on how it can apply its funds and which funds can be used to meet debts. Therefore the special circumstances of charities and fund accounting need to be considered.

## Funds of a charity

The principles of fund accounting require careful consideration in any insolvency situation. In the first place this is relevant when considering the tests described above as it will govern what amounts are available to meet different liabilities. The distinctions between income and capital and unrestricted and restricted funds permeate through trust law. Income includes all resources which become available to the charity and which the trustees are legally required to apply in furtherance of the charitable purposes within a reasonable time. This will include the funds held by branches and also restrict income funds. Capital, on the other hand, must be invested or retained.

In addition, due to the constraints of trust law and the important matter of donor imposed restrictions. Many charities receive significant amounts of restricted resources and these restrictions often affect types and levels of services and how funds can be used to meet liabilities. Consequently, information about the nature of net assets and the funds to which they are attributable is vital in assessing a charity's ability to respond to short-term needs or debt payments. Fund accounting requires that the resources of a charity should be grouped according to the restrictions on their use as follows:

- **Unrestricted funds**

These are funds available for general use for any or all of the charity's permitted activities. Unrestricted funds include those that have been designated for particular purposes by the trustees of a charity. They can be undesignated at any time. These funds can be allocated against any potential liabilities of the charity.

- **Restricted income funds**

These are funds that can only be expended in accordance with specific restrictions. These arise either by the wishes of the donor or by the nature of the appeal. These funds are sacrosanct and can only be used for the purposes of the special trust that created the restriction. It is however possible to seek clearance from the

Charity Commission or the original donors (if the donors have reserved the right to alter the terms of the trusts) to vary the terms of the restriction.

- **Restricted capital funds**

These funds are funds that are not for direct application. Where the trustees have no power to apply capital as income it will be permanent endowment. Where the trustees have a power to expend it if necessary, this will be expendable endowment.

An expendable endowment should be treated as capital until the right to expend it is exercised in which case it should be transferred to income prior to application. Permission can be sought from the charity commission to use endowments in certain circumstances.

Fund accounting is important when considering the use of funds to meet liabilities when the operation is a going concern and there is also the important consideration of who can make a claim on restricted funds in the event of a winding up.

When considering both the balance sheet test and the cash flow test have an understanding of the funds of the charity and how and when they can be applied is important,

## **The position of trust funds**

A company cannot hold endowed funds as part of its own corporate property as it is implicit that a company is free to spend any or all of its property. A charitable company holds its capital and other restricted funds upon trust because the company cannot apply these funds indiscriminately in furtherance of its statutory objects. However, the liability of the members of the company in relation to its acts as trustee is still limited, and the directors of the company are still acting as the company's agents in relation to the business that the company transacts as trustee.

There is no objection, in principle, to the transfer of permanent endowment to a charitable company, but the company will hold the fund as trustees of the trust for investment that affects it. This is so whether the income of the trust is applicable for the objects of the company generally, or only for some particular purpose within those objects.

The Charity Commission have explained in CC12 that a fund which a company holds on trust is not part of the estate of the company which is available to the general creditors of the company in accordance with the rules of company law – see for example *Re Kayford Ltd (1975)*.

To access a fund which is held by a company on trust, a particular creditor would have to show the liability was incurred by the company in the capacity of trustee of that fund, and that the company as trustee accordingly had the right to settle the liability out of the fund.

A charitable company can receive gifts in a number of ways. It can receive gifts in augmentation of its corporate property (unrestricted funds). It can receive gifts on trust for its general purposes. It can receive gifts on trust for specific purposes within the objects of the company (restricted income funds). It can receive gifts on trust for investment (endowed funds). Gifts of the first type are available to a liquidator of the charitable company, even if they take effect after the commencement of the liquidation. Gifts of restricted assets are, apparently, not available to a liquidator of the charitable company. This seems to be just an application of the usual principle that property held by a company on a trust is not available to a liquidator of that company.

There appears to be some confusion in practice about which part of a company's estate is accessible by creditors in accordance with ordinary principles of company law, and which part of the company's estate is only accessible by creditors in accordance with the principles of trust law. Some insolvency practitioners are accustomed to argue that the whole of the property of a charitable company is available for the creditors of a company in accordance with the principles of company law, whether or not it is held on trust. The Charity Commission's view is that generally where the permanent endowment is held on special trusts this is not the case.



Special trusts are defined in *Section 287 of the Charities Act 2011* as “property which is held and administered by or on behalf of a charity for any special purposes of the charity, and is so held and administered on separate trusts relating only to that property”. In effect, a special trust is tantamount to a restricted fund.

The Charity Commission’s view is that funds which are held by a charitable company on special trust are not available to creditors in an insolvency, unless the creation of the trust can itself be impugned under insolvency law. Of course, where the charitable company has entered into commitments as trustee of particular funds, creditors will have the usual rights that they have when dealing with a trustee.

The Charity Commission is clear on their position and their views consider careful attention. In CC12 they state:

“Only liabilities which have been properly incurred in the administration of the particular trust can be met out of the trust property. It could be a breach of the charitable company’s duty as trustee to allow assets held on trust to be distributed to its creditors as if those assets were simply a part of the charity’s corporate property. Any director, liquidator etc who is responsible for committing the charitable company to such a breach of duty could be in breach of his or her fiduciary duty towards the charity. They could, therefore, be liable to make good a loss of its trust property.”

If there is concern about the protection of funds great care needs to be taken in the structural arrangements. This has been emphasised by the predicament faced by the Wedgewood Museum. In this unfortunate case, the Wedgewood Museum discovered it was responsible for the entire £134 million deficit of the Wedgewood Group Pension Plan as the ‘last man standing’ employer. The High Court ruled that the Wedgewood collection held by the charity was not held on separate charitable trusts. The collection was seen to be part of the charitable company’s corporate property available to meet its insolvency costs and liabilities (*Young and another v HM Attorney General and others* [2011] EWHC 3782 (Ch)).

The decision confirms that a charitable company holds its corporate property for its charitable purposes which becomes available for creditors in an insolvency. Therefore if the aim is to ring fence and protect funds it is important to structure the arrangements carefully to ensure that funds or assets held or to be held by a charity are subject to properly constituted special trusts and that the terms of such trusts are properly recorded.

### **Requirements to set up a trust (restricted funds)**

Many charities set up restricted funds in their accounts on the basis of perceived obligations without properly considering whether the funds are legally restricted. In *Knight v Knight (1840)* Lord Langdale MR outlined the three certainties required to create a valid express trust:

- **Certainty of intention**

It must be clear that the settlor intended that the property received by the Trustee, to be held in Trust, is a binding obligation and not just a moral wish. The language used by the alleged settlor must be imperative and without ambiguity.

- **Certainty of the subject matter or trust property**

The Trust property must be clearly identified, as must the entitlements of the beneficiaries in that property. It must be possible to clearly identify the property that is to be subject to the Trust. In addition, even if the Trust property is clearly defined, the share or shares in that property to which the beneficiaries are entitled must also be clearly defined.

- **Certainty of objects**

The beneficiaries or purposes for which the Trust property is held must be clearly identified.

### **Liquidation of charities**

There are no statutory insolvency proceedings for unincorporated charities and it will fall upon the trustees to carry out the orderly winding up of the charity for which professional advice should be sought.

Charitable companies have the benefit of established winding up procedures. A resolution can be passed for a creditors' voluntary liquidation or there can be a compulsory liquidation. The court will not normally order the compulsory liquidation of a charitable company on the ground of inability to pay debts until after a creditor has either:

- issued a 'statutory demand', and the demand has not been met
- obtained a court judgement against the charity, in relation to a claim against it, and that claim has not been satisfied.

In these circumstances the creditor can petition the court to wind up the company. Once a charitable company is being wound up it is placed under the management of liquidator. It is then too late for the directors to take action of their own to bring the charity out of insolvency.

To pre-empt action by the creditors, and having followed the guidance in CC12, the members can pass a special resolution to put the company into voluntary liquidation.

The creditors are paid off in order:

1. Secured creditors holding a fixed charge; secured creditors with a fixed charge over a specific assets can be paid from fixed charge realisations
2. The liquidator's fees and the expenses of liquidation
3. Preferential, such as occupational pension scheme payments and certain amounts to employees
4. Secured creditors holding a floating charge
5. Unsecured creditors.

## **The position of trustees and directors**

Trustees of unincorporated charities can be held to be personally liable for properly incurred debts of the charity if the charity has insufficient funds.

A limited company gives an added measure of protection to trustees but should not be seen as a method of removing all liability (see separate guidance note on Incorporation pros and cons).

Most charity companies are limited by guarantee. This means there are no shares and instead the members each guarantee to contribute to the company's debts up to a specified limit. Unfortunately, this sometimes gives a sense of false security.

The liability of the guarantors is the extent they would have to pay in the event of the charity being wound up; it has little to do with the liability of the directors as trustees of the charity. Furthermore, the memorandum of many charitable companies includes a clause that draws aside the corporate veil and limits further the perceived protection of incorporation.

The directors of a limited company can avail themselves of provisions in *Section 1157 of the Companies Act 2006* that offers similar statutory protection to that offered by the Trustees Act. In essence, if it appears to the court that a director is or may be personally liable for any negligence, default, breach of duty or breach of trust but has acted honestly or reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such a breach the court may relieve the director either wholly or partly from personal liability for the same. It has been held that Section 1157 does not apply to the concepts of fraudulent/wrongful trading which have been discussed in the following sections.

Section 172 of the Companies Act 2006 explains that directors of a company have a duty to promote the success of the company. It also explains that in certain circumstances they must consider or act in the interests of creditors of the company. The courts have considered when this "duty shift" takes place and the Court of

Appeal concluded that this happens “when the directors know or should know that the company is or is likely to become insolvent”.

## **Fraudulent trading**

*Section 213 of the Insolvency Act* provides that on the application of the liquidator of a company the Court may order that any persons who were knowingly party to carrying on the business of the company with intent to defraud creditors must make a contribution to the company’s assets.

For a fraudulent trading action intent to defraud creditors must be proved and the onus of proof is on the liquidator. There must be evidence of actual dishonesty.

For an insolvent charitable company, senior management, and not just the trustees, could also be made liable for fraudulent trading.

In *R v Grantham (1984)* the judge clarified that an intention to defraud could be inferred if a person incurred a debt, for example by obtaining credit, without knowing that there was good prospect of being able to meet the debt payments as they fell due.

Charity law also requires certain procedures to be followed when mortgages and secured loans are taken.

## **Wrongful trading**

*Section 214 of the Insolvency Act* introduced the concept of wrongful trading to protect creditors from the negligence of directors. It covers situations where there has been a failure to exercise proper diligence in managing the company and in taking corrective action when insolvency loomed even though directors may not have acted in bad faith or fraudulently. To establish wrongful trading the Court would need to conclude that at some time before the company went into insolvent liquidation the directors or shadow directors continued trading although they knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

It is worth noting that the law does not include the words wrongful trading – these words are included in the title to the section. The law itself almost focuses on ‘irresponsible trading’. The law was designed to cater for situations where the directors ought to be able to recognise that the company is in difficulty and moving towards insolvency and yet do nothing about protecting the interests of creditors.

## **Preferential transactions**

Much of the legislation is designed to protect creditors. *Section 239 of the Insolvency Act* deals with the issue of preferential transactions. These are any transaction entered into with a third party that puts them in a better position than they would otherwise have been, in anticipation of an insolvent liquidation. For example, paying off a creditor shortly before the company goes into liquidation thus ensuring that the creditor receives better settlement than other creditors who would normally have ranked equally. Such transactions can be set aside if they were entered into six months before the onset of insolvency. This period is extended to two years where the creditor is a connected or associated person.

A charity could fall foul of this legislation if it paid grants to beneficiaries or made a transfer to another charity in anticipation of insolvency and other creditors did not get fair settlement.

Similarly, *Section 238* deals with undervalue transactions and these are transactions with any party in which the company receives significantly less than the value of that which it has released to the other party. The time frame is two years before the onset of insolvency.

Trustees and directors should resist the temptation to apply funds for “good works” if it could be construed that the application of such funds would be seen as preferential transactions.

### **Mitigating circumstances**

The court will recognise mitigating circumstances. For example, if the directors took proper steps to minimise the potential loss to the company’s creditors. The ‘knew or ought to have known test’ is an objective one. The directors must act reasonably and diligently bearing in mind both the individual director’s own knowledge, skills and experience and the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as the director. A person with relevant professional or legal skills such as an accountant or lawyer would be judged on this basis and thus could be at greater risk.

Standards expected will vary from one case to another. In *Re Produce Marketing Consortium Limited (1989)*, the Judge held that the expertise expected of a director is much less extensive in a small company in a modest way of business with simple accounting procedures and equipment than in a large company with sophisticated procedures. There is also the issue of delegation to management in a charity and the question arises as to what level of care and duty would the courts expect of a non-executive trustee in a wrongful trading case.

### **Disqualification of directors**

After insolvency the Official Receiver or the Insolvency Practitioner is required to send the Secretary of State a report on the conduct of all directors who were in office in the last three years of the company’s trading.

The Secretary of State then considers what action needs to be taken and whether it is in the public interest to seek a disqualification order. An application is then made to the court for a disqualification order and will decide whether to grant it. There are a number of reasons why a Director may face disqualification and this could also lead to criminal charges and fines as well as becoming personally liable for company debts. Examples of conduct that could lead to disqualification include:

- continuing to trade to the detriment of creditors at a time when the charity was insolvent
- failure to keep proper accounting records
- failure to prepare and file accounts or make required returns
- failure to submit tax returns or pay over to the Crown tax or other money due
- failure to co-operate with the Official Receiver or Insolvency Practitioner.

### **Going Concern**

The Companies Act requires that the accounts are prepared on a going concern basis unless there is a reason to believe that this is not appropriate. Directors must consider whether the entity is a Going Concern. This means that there is an underlying assumption that the entity will continue in operational existence for the foreseeable future and that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

In addition to company legislation the issue of Going Concern is covered in Financial Reporting and Auditing Standards. Therefore the matters discussed below are relevant for all charities that prepare accounts that are required to give a true and fair view.

*Financial Reporting Standard 102* states:

“3.8 When preparing financial statements, the management of an entity using this FRS shall make an assessment of the entity’s ability to continue as a going concern. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue.”

“3.9 When management is aware, in making its assessment, of material uncertainties related to events or conditions that cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.”

“32.7A An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.”

“32.7B Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this section requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting and therefore the disclosure requirements of paragraph 3.9 apply.”

I am often asked what period the assessment made needs to be. Many believe that this is restricted to one year from the date of approving the financial statements but in fact this is usually better considered as a minimum period and if there was a foreseeable event in a later period it would need to be taken into account. The Auditing Standard on Going Concern explains that:

“It is not possible to specify a minimum length for this period: it is recognised in any case that any such period would be artificial and arbitrary since in reality there is no 'cut off point' after which there should be a sudden change in the approach adopted by those charged with governance. The length of the period is likely to depend upon such factors as:

- the entity's reporting and budgeting systems
- the nature of the entity, including its size or complexity.

“Where the period considered by those charged with governance has been limited, for example, to a period of less than one year from the date of approval of the financial statements, those charged with governance will have determined whether, in their opinion, the financial statements require any additional disclosure to explain adequately the assumptions that underlie the adoption of the going concern basis.”

In addition, auditors have to follow specific guidance and even if the going concern basis is appropriate but if there is a material uncertainty the financial statements must describe the principal events or conditions that give rise to the significant doubt on the entity's ability to continue in operation and management's plans to deal with these events or conditions.

Auditing Standards also requires that the Directors state clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business. This needs to be carefully worded so that it is not seen as a prophecy of doom. In some cases the auditors may draw attention to this in their audit report.

## **A stitch in time**

There is much that a charity can do to avoid a solvency crisis. Charities should ensure that they focus on careful cash management. There are a number of easy wins. For example many charities continue to have delays in receiving grants simply because they have not completed the paperwork. The message is that ‘Cash is king’ and cash forecasts for income and expenditure become a real must do.

Good management information is vital and it is important to reassess how the charity identifies what matters and records and reports on what matters. Knee jerk reactions are risky and careful consideration of reserves and how they can be used coupled with cost optimisation and a real focus on income can help manage the situation.

Uncertainty can lead to inaction but the status quo is rarely the best option, however avoid knee jerk and uncoordinated actions. Trustees and management will need to consider many factors and evaluate many possible outcomes and make strategic responses to ensure that the charity is agile, conscious of different factors and resilient.

It is important to realise that many decisive actions may need to be taken promptly and the charity should ensure it has a decision making process that is nimble and well attuned to gathering relevant knowledge and different perspectives.

The Board and management should have action plans for different scenarios and they should monitor trigger points and trend analyses to enable the charity to decide when it needs to put the plans into place. They should look beyond the obvious and recognise that although the impact on income generation may be some way away a drop in income can occur suddenly. Therefore, good communication and careful evaluation and forecasting are needed. Focus on the relationship of income with expenditure and the nature of costs.

For example, if the organisation is one with many fixed costs then it may need to remember it is vulnerable to 'super tanker' trends – as income deteriorates it may not be able to reduce costs at the same speed. By the time the 'super tanker' has the rocks in its sights; it can run out of clear water that is needed to change direction in time. The 'clear water' for a charity that is trying to react to reducing income may be generated by reserves or by taking early action on costs. Bear in mind the impact of inflation and that if income is constant it has actually reduced in real terms.

There may be a need to focus on core activities and discard the periphery, but beware the trap of cutting activities and expecting that this will result in all their costs being removed. One well known charity entered into a laudable project of considering which of its activities were providing the best return and then cut out the less 'valued' ones expecting to see a reduction in all related costs. However, many fixed costs that had been allocated to these activities had to now be absorbed by other activities.

Directors and Trustees should ensure that they do not trade when the charity is insolvent, unless they can show that they made a considered decision that there was a realistic prospect that the charity would avoid insolvent liquidation. They should also not take credit or loans that they know they have little prospect of repaying. Similarly, they should not take advances or enter into contracts to deliver goods or services when they believe that there is a low likelihood of delivery.

If the charity is facing a solvency crisis it is important that all decisions are carefully made and properly recorded. There is also need to record the matters that were considered and the extent of the deliberations to ensure that, if it was needed, there is a record that the Board and management were diligent and took the situation seriously.

The Charity Commission has issued guidance '*It's your decision: charity trustees and decision making*' (CC27)<sup>2</sup>. This explains that "Trustees must take decisions in a way that meets the requirements of charity law and their governing document. This includes:

- following any specific requirements in the governing document about making decisions and conducting meetings
- taking decisions jointly (collectively), making sure all trustees have the opportunity to participate
- if using a power to take decisions outside of a meeting, strictly following the provisions of this power
- if delegating to staff or sub-committees, having clear and robust reporting procedures and lines of accountability in place
- recording decisions properly, so there is no doubt about what was decided and why."

The frequency of Board meetings and briefings from management may need to increase and it is vital to show that the Board received proper and up-to-date information to really evaluate the financial position.

<sup>2</sup> <https://www.gov.uk/government/publications/its-your-decision-charity-trustees-and-decision-making>

Finally, it is important to recognise that hard times can offer opportunities as well as challenges. Cost cuts and needed change that may have met opposition in good times are often accepted when there is a down turn. There is also opportunity to renegotiate costs. As others cut back on fundraising and marketing costs it is usually possible to reach more supporters for less expenditure. There are some great deals to be made with media channels. Buyers are able to drive harder bargains with agencies and improve payment terms.

## In conclusion

This guidance note focuses on what happens when things have gone wrong but prevention is the best medicine and in CC12 the Charity Commission has stated:

“Insolvency can happen overnight, for example where a charity is dependent on grant income which is cut and not replaced by other sources of income. It may also creep up slowly over several years and remain unchecked until the charity can no longer finance its activities.

“It is essential for a trustee body to have a good knowledge and understanding of the charity and its finances. Although it can be difficult to prevent the overnight collapse, even if it is anticipated, it ought to be possible to prevent or delay the onset of creeping insolvency.

“The action necessary can be summed up as being ‘effective management and control’. The responsibility for creating this environment rests with the trustees, but will involve all staff members whether paid or volunteers.”

The task of setting priorities for charities will be even more difficult than ever, matching the increasing demands to satisfy short term needs against pressure for the resources required to achieve long term solutions.

The charity sector is going through, and will continue to face, a period of real challenge and change. Necessary change must not be brought about at the expense of motivation and clarity of vision and purpose. There are no stereotyped solutions, but sharing information and an understanding of the operational realities and the regulatory perspectives will help.

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**Pesh is Special Advisor to the Charity Finance Group and having been a member of the Committee that produced the 1995, 2000, 2005 and 2015 Charity SORPs he has a wealth of knowledge and expertise on reporting by charities. He is also a member of the Practitioner Advisory Group that provides advisory input and feedback in the development of the world’s first Internationally applicable Financial Reporting guidance for non-profit organisations. He was a member of the Accounting Standard Board’s Committee on Accounting for Public Benefit Entities and was also a member of the Charity Tax Commission.**

**Pesh was the partner leading teams working with social purpose and non profit organisations at Crowe, Deloitte, Arthur Andersen and BDO Binder Hamlyn. During this time these firms have been listed as the lead provider of audit services to charities for the 30 consecutive years. He now provides wide ranging consultancy services to Social Purpose and non-profit organisations.**



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## Appendix 1 – Relevant extracts from the Insolvency Act 1986

### 122. Circumstances in which a company may be wound up by the court

(1) A company may be wound up by the court if:

- (a) the company has by special resolution resolved that the company be wound up by the court
- (b) being a public company which was registered as such on its original incorporation, the company has not been issued under *section 117 of the Companies Act* (public company share capital requirements) and more than a year has expired since it was so registered
- (c) it is an old public company, within the meaning of the *Consequential Provisions Act*
- (d) the company does not commence its business within a year from its incorporation or suspends its business for a whole year
- (e) except in the case of a private company limited by shares or by guarantee the number of members is reduced below two
- (f) the company is unable to pay its debts
- (g) the court is of the opinion that it is just and equitable that the company should be wound up.

(2) In Scotland, a company which the Court of Session has jurisdiction to wind up may be wound up by the Court if there is subsisting a floating charge over property comprised in the company's property and undertaking, and the court is satisfied that the security of the creditor entitled to the benefit of the floating charge is in jeopardy.

For this purpose a creditors' security is deemed to be in jeopardy if the Court is satisfied that events have occurred or are about to occur which render it unreasonable in the creditor's interests that the company should retain power to dispose of the property which subject to the floating charge.

### 123. Definition of inability to pay debts

(1) A company is deemed unable to pay its debts:

- (a) of a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company's registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for three weeks there-after neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor, or
  - (b) if, in England and Wales, execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part, or
  - (c) if, in Scotland, the induciae of a charge for payment on an extract decree, or an extract registered bond, or an extract registered protest, have expired without payment being made, or
  - (d) if, in Northern Ireland, a certificate of unenforceability has been granted in respect of a judgment against the company, or
  - (e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.
- (2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

### 213. Fraudulent trading



(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

#### **214. Wrongful trading**

(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

(2) This subsection applies in relation to a person if:

(a) the company has gone into insolvent liquidation

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time; but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.

(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2) (b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

(4) For the purposes of subsection (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both -

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that the director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

(7) In this section 'director' includes a shadow director.

(8) This section is without prejudice to section 213.