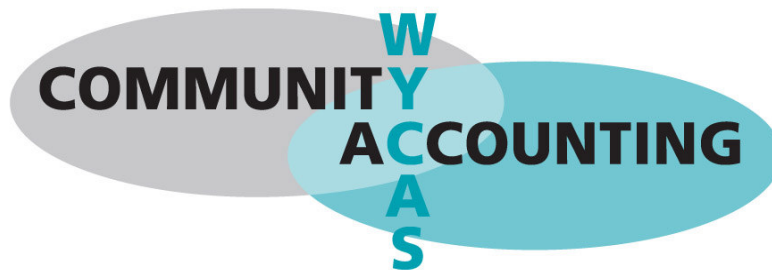


Good Practice Guide No 22

Financial difficulties and Insolvency



West Yorkshire Community Accounting Service

Introduction

Many charities and voluntary organisations only realise they are in financial difficulty when the money runs out and they can't pay the staff or the bills. There are a number of things which could and should be done on an ongoing basis to monitor the organisations financial performance in order to avoid insolvency.

What is Insolvency?

Insolvency only occurs when either the bills can't be paid when they are due or the balance sheet liabilities exceed the realisable assets taking into account possible and prospective liabilities.

Insolvency Law

The law for **company** charities is laid out in the Insolvency Act and it is good practice for charities / organisations that are not companies to adopt the same approach.

Company charities are "legal entities" which can incur liabilities and become insolvent. When directors know or ought to have known that the company was insolvent they are legally required to take every step to minimise the potential loss to its creditors. Continuing to operate is known as wrongful trading and is an offence. If in the course of winding up a company the insolvency practitioner finds that there has been "wrongful trading" he can apply to the court to make the directors personally responsible for the debts. Most company charities are limited by guarantee with a maximum liability of £10 per member and that would be the limit of the directors' liabilities unless they are found guilty of wrongful trading.

Unincorporated charities and voluntary organisations are not "legal entities" and cannot technically incur liabilities, these are incurred by the trustees running the organisation. If a decision to incur a liability was made at a meeting where all trustees had been given notice of the meeting then each and every trustee shares the responsibility for the liability. Unless debts and liabilities have been incurred on the basis that there are sufficient funds to pay them, the trustees may be personally liable if there are insufficient funds in the charity / organisation. In this context restricted funds and endowments do not form part of a company's funds as they are held in trust by the directors.

Insolvency tests

There are 2 tests for insolvency:

1. The cashflow test.
This shows whether a charity has sufficient resources (cash, short-term debtors and investments) to pay all its immediate liabilities and

to continue to pay them in the short-term. How long the “short-term” is will vary according to the charity.

2. The balance sheet test.
This shows whether the charity has enough assets (fixed and current) to meet actual and anticipated liabilities in both the short term and long term.

What are the signs of insolvency

There are a number of signs of insolvency, which will vary from charity to charity, but some difficulties would be:

1. Current assets and investments are less than the current liabilities.
2. Total assets and foreseeable income are less than the total liabilities and expected expenditure.
3. Having to use reserves on a regular basis because there isn't enough income to cover costs.
4. Additional security is needed for long-term borrowing.
5. Creditors are chasing bills which cannot be paid.

If any of these signs are applicable it should not be automatically assumed that the company is insolvent, more detailed analysis will be necessary to make the decisions.

Care should be taken not to include restricted or endowment funds or assets which still have a restriction in the calculations.

Despite appearing insolvent many organisations continue as going concerns and are not forced to wind up. For example organisations may in the short-term appear insolvent but be waiting for a late payment of a grant or contract.

If the charity appears to be insolvent professional advice from an insolvency practitioner should be sought before remedial action is taken. A list of insolvency practitioners can be found at <http://www.insolvency-service.co.uk/newipsearch.htm>.

How can we prevent becoming insolvent?

Insolvency can happen immediately if a grant is cut or a contract lost and no other sources of income are available, or it can creep up over a period of time when expenditure consistently exceeds income.

Trustees should have a good knowledge and understanding of the charity and its finances and should be able to prevent insolvency due to “creeping insolvency”. Effective management and financial control is essential in order to prevent this.

Effective management

1. The trustees should have the time to spend running the charity and have the appropriate skills.
2. There should be regular trustee meetings where financial reports are provided and considered.

Trustees may want to read the Charity Commission publication: CC10 – The Hallmarks of an Effective Charity.

Effective financial control

1. Business plans, budgets and cashflow statements should be produced on an annual basis. Expenditure should include all known liabilities and any contingencies.
2. Trustees should review performance by comparing actual income / expenditure to budgeted income / expenditure on a monthly basis. This may be more often if the charity is in difficulties or less often if it is stable.
3. Types of income and expenditure should be looked at and income diversified wherever possible so “all the eggs are not in one basket”. If there is only one source of funding and that ceases problems arise.
4. Trustees should take advice before entering into long-term contracts eg. leases, loans or building contracts to ensure that they will be able to pay them back.
5. The performance of any investments should be monitored and a diversified portfolio held. Professional advice may need to be taken for this.
6. Robust financial controls should be in place.
7. VAT (Value added tax), PAYE (Pay as you earn) and NIC (National insurance contributions) should be correctly accounted for as errors may incur penalties.
8. Insurance should be held to ensure that any unexpected accidents, claims etc do not have to be funded by the charity.
9. A reserves policy should be in place and where there are reserves held this may see the charity over a difficult period.

In order to carry out the above, sound book-keeping and reporting systems need to be in place. The book-keeping system should be able to identify unrestricted, restricted and endowment funds where appropriate.

Where a charity is heading for insolvency and has fixed assets it is prudent to assess the realisable value of the assets should they have to be sold.

Available options before deciding to wind up

Before the trustees finally decide to wind up the charity the following options should be considered:

- Can expenditure be cut so that outgoings are less than income but the objects still be fulfilled.
- Can alternative sources of funding be found?
- Can an emergency appeal be launched – care must be taken to ensure the funds are unrestricted in order to be used to pay off creditors.
- Review commitments to see if they are legally binding. Contracts may be able to be renegotiated.
- Can any activities be discontinued to cut down on expenditure or free up assets which can be sold.
- Can the charity merge with another with similar objects and then be able to pay the creditors.
- Can money be borrowed from supporters perhaps interest free. There must be the possibility of paying any loans back in the future.

When insolvency is inevitable

Once the trustees know, or ought to know, that there is no way of avoiding becoming insolvent there is a legal requirement that every step should be taken to minimise the loss to creditors.

Paying professional fees for advice is a justifiable expense on the grounds that the trustees are taking appropriate steps to find the best way to meet the creditor's claims.

Winding up a Company Charity

There are different ways in which a company can be wound up:

- Corporate voluntary arrangement (CVA)
- Member's voluntary liquidation (MVL)
- Creditors voluntary liquidation (CVL)
- Compulsory liquidation

Corporate voluntary arrangement (CVA)

A company charity may enter into a CVA under section 1 to 7B of the Insolvency Act. The company agrees with its creditors a “composition in satisfaction of its debt” or a “scheme of arrangement of its affairs”.

The creditors agree to accept a reduced payment or delay in payment. The arrangement with the creditors has to be approved by the court.

A CVA can be proposed by the directors, an administrator or liquidator but the proposal or arrangement must be supervised and administered by an insolvency practitioner.

Member’s voluntary liquidation (MVL)

A company can go into MVL when the directors believe that the company is solvent. In order to go into MVL a majority of the company’s directors have to make a statutory declaration of solvency in the 5 weeks before a resolution to wind up the company is passed.

The declaration states that the directors have fully looked into the affairs of the company and believe they will be able to pay all the creditors in full within 12 months from the start of winding up. The declaration includes a statement of the company’s assets and liabilities at the latest practicable date before making the declaration.

The winding up starts when members, in a general meeting, pass a resolution (usually a special resolution) to wind up the company voluntarily.

Creditors voluntary liquidation (CVL)

A CVL is appropriate when a company cannot pay its debts.

The company must pass a special resolution to say it cannot continue in business because of its debts and that it is advisable to wind up.

The resolution must be advertised in the Gazette within 14 days and sent to the Registrar within 15 days. A meeting of creditors must be held within 14 days of passing the resolution; creditors must be given at least 7 days notice of the meeting. The directors must prepare a statement of affairs for consideration at the meeting. A liquidator will then be appointed.

Compulsory liquidation

Compulsory liquidation is when a court orders the company to be wound up.

A company is regarded as unable to pay its debts if a creditor

- Is owed more than £750;

- Presents a written demand in the prescribed form to the company; and
- The company fails to pay, secure or agree a settlement of the debt to the creditors reasonable satisfaction.

The court may also order the company to be wound up on the petition of:

- The company itself;
- The company's directors or one or more members;
- The Secretary of State for BERR
- The FSA; or
- The Official Receiver

The types of arrangements for company charities are:

1. Winding up (as above)
2. Moratorium
3. Administration

An insolvency practitioner must act in all the above

4. Receivership
5. Administrative receivership.

The official receiver must act in the above.

Detailed information can be found in Companies House document – Liquidation and insolvency (GBW1) - Chapter 2 for CVA, Chapter 5 for MVL and CVL, Chapter 6 for compulsory liquidation.

<http://www.companieshouse.gov.uk/about/gbhtml/gbw1.shtml>

Winding up an Unincorporated Charity/Organisation

There are no statutory insolvency proceedings for unincorporated charities / organisations. The trustees of an unincorporated charity / organisation facing insolvency can agree an informal arrangement with its creditors. The creditors might decide to defer payment and / or agree to reduce the size of their claims. This arrangement is outside the provision of the Insolvency Act. The arrangement only applies to the creditors who sign up to it. Professional advice should be taken before agreement is made. If a decision is made to wind up the charity / organisation should follow its governing document. The charity trustees should carry out an orderly winding up, taking appropriate professional advice, identifying and paying liabilities and distributing any remaining assets in accordance with the governing document.

The trustees should then send to the Charity Commission

- A copy of the resolution to wind up the charity
- The final set of accounts with the correct scrutiny. (The commission should be informed if there is insufficient funds to meet the costs of the external scrutiny)
- A statement of the final distribution of funds if this is not shown in the accounts. (This should be signed by the trustees and preferably by the external auditor / examiner).

Once satisfied with the information sent the charity will be removed from the register.

After being dissolved or wound up

Trustees have a duty to tell the Charity Commission when the charity has wound up and the Charity Commission will remove them from the register under S3(4) of the 1993 Act.

Company charities can be dissolved (removed from Companies House register) without winding up; if this occurs then the directors should inform the Charity Commission. If a company charity is wound up the liquidator would normally inform the Charity Commission that the company has been dissolved under the Companies Act 1985.

Case study from “Cutting the Cloth” by Peter Scott

‘A financial review caused a phone call to the writer the following morning. The new chair of trustees wanted to meet to discuss the financial state of affairs of the charity. The charity in question had been set up by an entrepreneurial businessman ten years before to provide support for bereaved children of service men in the armed forces. The founder had experienced such loss at the age of 12. The charity, ‘New Day Dawning’, had a team of eight employed case workers, a chief executive and a finance officer plus part-time administrative backup. The charity had always been heavily dependant on the continued financial support it received from the Gift Aid donations of the entrepreneur’s group of companies. News had just broken that the group was in financial difficulties and the finance officer had been told that the charity could expect the January quarterly donation but nothing beyond that for the foreseeable future. The chair brought with her the CEO and finance officer and we looked at the latest financial statements and the cash reserves.

First steps

The chair and the charity officers were uncertain whether they should approach their solicitors first or their accountants. We explained that usually trustees in such circumstances wanted to understand their legal obligations and the framework within which they had to operate before deciding what to do next. Often in practice it is a matter of where the key relationship lies as to which profession charity officers approach first. Either way the issues are legal and accounting, and the professional team will be put together with the appointment of an insolvency practitioner at some stage. The key decision is to take professional advice immediately; not sit on hands or worse still rush for the exit doors. Trustees have a duty to act responsibly in the interest of the charity, its beneficiaries and its creditors. Even if resources are clearly inadequate to make ends meet, no trustee will be faulted for taking professional advice in such circumstances.

In the case of New Day Dawning, it was a company limited by guarantee of which the trustees were the directors. The first question to determine, if possible, was whether the charity was insolvent? Was it unable to pay its debts as they fell due or was the value of its assets less than the amount of its liabilities (taking into account possible or prospective ones?). It appeared that the answer to both questions was 'no'; applying the statutory test under the Insolvency Act 1986, resulted in a negative. At least for the next 12 months it appeared that the charity would be able to pay its debts as they fell due and the value of its assets was greater than the amount of its liabilities. Beyond the 12 months however, if current levels of expenditure were maintained and the lost income from the supporting companies was not replaced, it was abundantly clear that the charity would become insolvent.

It emerged that another uncertainty lurked rather menacingly on the horizon: the property occupied by the charity was provided free of charge by one of the group companies. The CEO had been warned by the managing director of the company in question that its bankers were requiring it either to sell the property or to charge a full rack rent to the charity within 12 months. This would be an unbudgeted item for the organisation.

New Day Dawning had built up a good reputation for service delivery in the ten years it had been operating and the new chair, who had only taken over the role from the founder entrepreneur six months before, was determined to protect the reputation of the charity if that was possible in the circumstances.

The first question the chair had was: what is our position as the trustees where we know that unless things can be turned around New Day Dawning will be insolvent in 12 months time? Dependant as it was on the group of companies for half its income and its accommodation the writing seemed to be on the wall. Could the trustees be personally liable for the financial consequences of continuing to run the charity now they were aware of the problems? The answer was that currently the charity was not insolvent and that, provided the trustees engaged themselves on the basis of professional advice and adopted a proactive approach with a full and clear understanding of the financial position, then they should not incur personal liability. If however, they continued to run the charity beyond that point then that would be a different matter.

Trustee issues

The chair was advised that the next step was to hold an emergency meeting of the trustees attended by both the auditor (briefed by the finance officer) and their legal representatives. A meeting was quickly held at which all trustees were able to attend. The accountant confirmed the current cash position as set out by the finance officer and the analysis of the balance sheet was updated with realisable values and also a first estimate of redundancy costs in the event of winding up the charity.

The CEO provided a full report on the prospects of new sources of funding. He also provided a first draft of an options paper for the charity, ranging from continuing on current basis to winding up. The key feature of the meeting was

to ensure there was full understanding by the trustees of the financial situation. It was resolved that the trustees from now on would meet monthly rather than quarterly and that a small sub-committee comprising the chair, one other trustee, the CEO and the finance officer would meet weekly to bring forward to the next trustee meeting proposals for the way forward with input from professional advisors.

The working party's brief was to advise the trustees on whether there was a realistic prospect of avoiding insolvency. The advice to the trustees was that this was the key question the working party should address because if the position was unavoidable then there was a duty on the part of the trustees to take every step to protect creditors. This responsibility arose under the Companies Act and the trustees were advised of the offences of wrongful trading and the perils of fraudulently preferring one creditor over another. Either or both of which offences could result in personal liability for the trustees.

At the emergency meeting of the trustees, one of the trustees raised the questions of the trustees indemnity insurance (TII) and whether that or any of the other insurances they had taken out covered them against the risks of personal liability and also whether there was any cover for the loss of major sources of donated income. The response was that no policy would give the trustees protection if their conduct could be described as reckless in dealing with the current situation. However, if they exercised sensible judgement with a full understanding of the financial information and took professional advice then there was some assurance to be gained from TII. They were also advised that no policy would give the charity protection against financial claims or debt which it could not meet.

Funding and accommodation issues

Ten days later the working party met with accountant and solicitors present. The chair and the CEO reported that they had met with its corporate sponsor, the founder entrepreneur who confirmed that the position was regrettably as they had been informed. His hands were tied by his bankers and he had gone out of his way to guarantee the January payment and the 12 months grace given on the occupation of the building. He made several suggestions as to possible sources of new funding to support the cause given the charity's good work and excellent reputation.

The CEO reported that he was exploring those avenues and that he had approached grant giving bodies for funds. While all were sympathetic the actual funds resulting were likely to be modest. He had approached a sister charity which focused on the education of similar beneficiaries and they had agreed to meet and discuss but it had no surplus funds. Encouragingly, the charity did have surplus accommodation in their premises and were willing to make this facility available to New Day Dawning.

Cashflow

The accountant reported that he had been through the financial statements with the FO and in particular the cash flow projections for the next 12 months.

They had now produced a series of cash flow projections distinguishing between legally binding commitments, morally binding ones and non-binding ones. They also looked at what scope there was for sale and lease back of assets, particularly the 12 motor vehicles and office equipment owned by the charity. In order to generate additional cash. Further work had also been done on various redundancy scenarios to allow for a managed reduction of delivery through to closure within 12 months.

By the next trustees meeting the CEO and FO were able to produce a first report on whether there was a realistic prospect of avoiding insolvency at New Day Dawning. The recommendation was to downsize the operations and explore the possibility of shared working with the sister charity. The trustees approved opening immediate discussions to that end and approved commencing the first round of redundancies. At the time of writing negotiations are ongoing with the sister charity and the trustees are fully engaged in the process. Management is rising to the challenge and it does seem that the beneficiaries will continue to be supported. An emergency appeal has been launched.

Learning points

This case study in which the identities have been anonymised, is an example of the financial problems challenging charity trustees as the need for services from charities continues to diverge from the means to provide them. In this case of course the problems were significantly exacerbated by the sudden indication of the loss of the major financial support for the charity.

Key points of guidance to be drawn from the case study of New Day Dawning are as follows:

- It is essential that charity trustees 'know where they are'; that they have a full understanding of the cash flow projections of their charity.
- A realistic assessment of the realisable value of assets is crucial.
- Charities must understand and recognise the distinction between restricted and unrestricted funds both of capital and income.
- They should identify whether asset values have been permanently impaired or whether there is a realistic prospect of recovery of values with improved markets.
- There needs to be an understanding of the cost of realising such assets and the likely professional charges in advice generally.
- Liabilities must be clearly distinguished between those which are legally binding, those morally binding and those non-binding.

The importance of 'knowing where they are' is that trustees can come to an informed view when they are financially challenged on whether there is a realistic prospect of avoiding insolvency – or not.

In the case study the alarm bells were sounded by the finance officer as a result of information received from the major donor; some cases do result from a single unforeseeable event but many others are as a result of a gradual slide where the position can be exacerbated by a downturn in market

conditions. The trustees in New Day Dawning should have identified years ago in their risk register their dependency on a single source of finance’.

‘Cutting the Cloth’ by Peter Scott is © CaritasData can be found on pages 7 to 9 of *Caritas*, issue 15, February 2009 and online at www.charitiesdirect.com/caritas-magazine in the February 2009 issue.

Glossary

The Insolvency Act means The Insolvency Act 1986, as amended by the Insolvency Act 2000 and the Enterprise Act 2002.

Company charities means a charity which is a company formed and registered under the Companies Act 1985, or to which the provisions of that Act apply.

Endowment funds are funds which the trustees are legally required to invest or to keep and use for the charity's purposes. Endowment may be expendable or permanent. Trustees have the power to apply expendable endowment for the purpose of the charity.

Going concern means the ability of an organisation to continue in existence for the foreseeable future.

Governing document means any documents which sets out the charity's purposes and, usually, how it is administered. It may be a trust deed, constitution, memorandum and articles of association, Scheme of the Commissioners, conveyance or will.

An **insolvency practitioner** is an individual qualified under Part XIII of the Insolvency Act to act in various capacities, including, in the case of corporate insolvency, as liquidator, administrator, administrative receiver or as the nominee/supervisor of a company voluntary arrangement.

Restricted funds are funds to be used for specific purposes, set out by, the donor or the terms of a public appeal within (but narrower than) the objects of the charity.

Trustees means charity trustees. Charity trustees are the people who are responsible for the general control and management of the administration of the charity.

Directors means the charity trustees of a company charity.

Unincorporated charity means a charitable trust or association.

Unrestricted funds are funds to be spent at the discretion of the trustees in furtherance of the charity's objects.

Must or need are terms used to refer to actions that the trustees, or their agents or employees, have to take by law.

Acknowledgements

Companies House publication GBW1 – Liquidation and Insolvency.
Charity Commission publication CC12 - Managing Financial Difficulties and Insolvency in Charities.

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Further information

Charity Commission – www.charitycommission.gov.uk
CC12 Managing Financial Difficulties and Insolvency in Charities
CC10 The hallmarks of an effective charity
CC37 Charities and Public Service Delivery
CC35 Charities and trading
CC14 Investment of Charitable Funds
CC49 Charities and Insurance
RS5 Small charities and reserves

Companies House – www.companieshouse.gov.uk
GBW1 Liquidation and insolvency.

Business Link – www.businesslink.gov.uk
Avoid insolvency
Insolvency & Bankruptcy

The Voluntary Sector Legal Handbook - Sandy Adirondack & James Sinclair Taylor.

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Website: www.wycas.org.uk

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