

MANAGING YOUR SOLVENCY



**A guide to insolvency
and how to ensure
that you continue as
a going concern**



edited by
Michael Norton

A DIRECTORY OF SOCIAL CHANGE PUBLICATION

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FOREWORD

This is a book about the dangers and problems of **insolvency** and how to avoid it. But it is also a book about **solvency**. In the present funding climate for charities and other voluntary organisations, and with increased emphasis that many voluntary organisations are placing on earning their money from contracts and through marketing their services, it is as important for such organisations to create a robust financial structure for their operations that will enable them to come through periods of difficulty – and remain solvent – as it is for those organisations operating at the margin to prevent themselves from tumbling into the abyss.

The concern with solvency and insolvency is also a consequence of the 1993 Charities Act. This introduces new accounting standards for charities (due to come into force in 1994), which will focus attention on liabilities and contingent liabilities – and whether the charity has sufficient assets to cover these. The Act also emphasises the personal responsibility that charity trustees have to see that the affairs of their charity are in good order, and to ensure not only that the charity is meeting the needs of its beneficiaries, but that it will be there in future to meet the needs of future beneficiaries.

The book is aimed at

- **Charity Trustees** – all the trustees – as they have collective responsibility for the affairs of the charity, and at the members of the management committees of non-charitable voluntary organisations. But particularly at the Chair and the Treasurer who have more specific reasons for being concerned
- **Charity and Voluntary Organisation Directors and Financial Directors**, and throughout the book there are very practical ideas which might be relevant, and which could be put to the trustees for decision
- **Professional Advisers**, especially accountants and auditors. Charity and voluntary sector finances are, in some respects, very different from the finances of commercial concerns, and some of the issues and ideas discussed in this book may not be universally familiar in the professional accountancy world
- **Advisers**, including intermediary organisations and consultants, responsible for advising on management and financial strategies

- **Funders**, and especially local authorities, other statutory funders and grantmaking trusts. Many funders are concerned to see that the organisations they want to support are well enough funded and structurally sound enough to do a good job. Often the funders have been part of the problem – by underfunding (partly as a result of grant-seekers applying for too little in the first place, because they think that paring down an application will increase its chances of success), or through clawback (if a grant is not fully spent or funds are raised elsewhere). This has created an often under-resourced voluntary sector, just at the time when there are great changes and challenges. This book gives the funder a chance to be part of the solution.

The book has been produced collectively by a group of people with different perspectives on the problem. Its genesis was a discussion at the Charity Law Conference in January 1993, where it was apparent that issues of solvency and viability were of wide concern. A small working group was convened to discuss what might be done, and this book is the result.

The team who have contributed to the book include lawyers and accountants specialising in charities, an insolvency practitioner, and ‘experts’ with financial and management expertise. The book consists of a series of contributions offering a range of perspectives on the meaning and implications of insolvency and the importance of maintaining a robust organisation which is able to continue as a going concern. Inevitably there is some overlap between the different chapters. Some of this overlap has been edited out, but some has been retained to allow each contributor to make the points that they felt to be important from their own particular perspective on the problem.

We hope that the book will fulfil a valuable role in highlighting an area of interest and concern to charities and their supporters, and by presenting a number of practical steps which might be taken to improve the robustness and the long-term financial health of charities and other voluntary organisations.

About the contributors

Stephen Lloyd is a partner with solicitors Bates Wells and Braithwaite, an expert in charity law, a frequent speaker at seminars and conferences, and author of a publication on *Charity Trading and Charity Law*.

Peter Gotham is a partner in Gotham & Co, Chartered Accountants, who specialise in the not-for-profit and small business sectors. He is also a partner in Taylor Gotham, Insolvency Practitioners, and is a Licensed Insolvency Practitioner with (unfortunately) considerable experience in charity insolvency.

Adrian Randall is Director of Finance of the Cancer Research Campaign. He is also Professor of Accounting at South Bank University, Chairman of the Charities' Tax Reform Group and a co-founder and the first Chairman of the Charity Finance Directors Group.

Pesh Framjee is the partner in charge of the Charity Unit at BDO Binder Hamlyn Chartered Accountants which acts for over 350 charities. He is also co-ordinator of the Charity Finance Directors Group and writes and lectures extensively.

Lindsay Driscoll is Legal Adviser to the National Council for Voluntary Organisations, spending most of her working life dispensing advice and speaking at conferences.

R Greyham Dawes is an accountant on the staff of the Charity Commission, which has concerns for the financial health of charities as well as to support the role of trustees in their governance and supervision.

Kate Sayer is a partner in Sayer Vincent, a firm of accountants specialising in charity, housing association and voluntary sector accounts. She is a co-organiser of the annual Charity Accountants Conference, and she and her staff do extensive training on accounting and financial management for charities and voluntary organisations.

Michael Norton is Director of the Directory of Social Change, a national charity promoting effective management and good practice in the voluntary sector, which runs an extensive nation-wide programme of technical training for charities. He is co-author of *Accounting and Financial Management for Charities*.

The editor would also like to thank:

Sandy Adirondack, an independent trainer and consultant and author of *Just About Managing*, for a thorough reading of the manuscript and helpful comments to the text.

Mike Hudson, a partner in Compass Partnership for his help with Chapter 7.

This book is a distillation of the technical expertise, experience, ideas and wisdom of these ten people who together comprised the Insolvency Working Group.

Terms used

Charities come in a variety of different legal structures. The titles of those responsible for their governance and their legal duties and responsibilities vary according to the structure under which the charity is constituted.

The main responsibilities for those responsible for the governance of charities are:

- As **charity trustees**: they have the responsibility under charity law as trustees for the funds they are responsible for to see that they are properly applied, and to see that all the requirements of charities law are met.
- As **management committee members**: they plan, implement and oversee the charity's work programme, and have legal responsibilities under a wide variety of legislation – including employment law, health and safety at work law, etc.
- As **company directors**: for those charities constituted as companies under the Companies Acts or where they are directors of an associated trading company, to comply with the Companies Acts and other legislation affecting companies.

Whoever they are, they must also at all times:

- Operate within the constitution of the organisation,, which defines its purposes, their powers, and the procedures for running the organisation.
- Operate within the law.

The titles of those responsible for the affairs of the charity are not always used consistently. Thus the Directors of a charitable company may be referred to as Charity Trustees (which they are under the Charities Act), but the Chief Executive may be referred to as The Director.

For the purposes of this book, we have tried to be consistent, and use the terms as follows:

- **Charity Trustee or The Trustees**: This refers to those people who have the overall responsibility for running the charity. This includes the trustees of a charity constituted as a trust, the directors of a charity constituted as a company or an industrial and provident society, and the management committee of a charity constituted as an unincorporated association or society. They have both trustee responsibilities and management responsibilities. We use these terms when discussing matters that refer to all charities.
- **Directors**: This refers to the directors of a charitable company or any person occupying the position of director by whatever name called. Directors of companies have additional responsibilities under company legislation. We use this term for those situations which are relevant to those charities constituted as companies and for situations where the

legislation also covers unincorporated associations. The Directors will normally also be the trustees of the charity.

- **Shadow Directors:** This refers to those people in accordance with whose directions or instructions the Directors are accustomed to act. They are not directors as such, but they have some of the responsibilities of directors, in that they may be held liable for wrongful trading.
- **Members:** This refers to the members of a charitable company who have each provided a guarantee (usually nominal) to the company in the event that the resources of the company are not sufficient to meet its obligations. Under insolvency law, the members of a company have certain rights (see Chapter 2). The term 'member' should not be confused with the membership of an organisation through some form of subscription scheme. Such 'members' are supporters or friends of the organisation. They may also be, but are not necessarily members of the company.
- **Insolvency Practitioner:** This refers to an individual having the necessary licence under the legislation to carry out liquidations and most other insolvency procedures.

Because charities are differently constituted, and because the registration, the accountability requirements, the insolvency procedures and the personal liabilities of those at the helm all vary according to how the organisation is constituted, we have tried throughout the book to show the particular situation as it will affect your organisation, but first you will need to know how your organisation is constituted.

INTRODUCTION

Solvency and insolvency

Insolvency is what happens when it goes wrong. At that stage, things move out of your control. **Solvency** is preventing your organisation ever getting near the insolvency zone. And **robustness** is the financial muscle and strength to ensure that the organisation is able to come through periods of financial difficulty.

Whether you are near to insolvency, or whether you think you might at some stage be so, or whether you are simply concerned to build a robust organisation that will never get near to being insolvent, the issue of insolvency is an important one. It is also important if you advise or fund charities or other voluntary organisations, for here you have the opportunity not just to give advice or support to keep them going in the short term, but to help give them the structures and the strategies to keep strong and healthy into the future.

Why insolvency is a problem

Insolvency (and the issue of solvency) is more than just a problem of the early 1990s recession – although the recession has created its own catalogue of insolvencies as much in the voluntary sector as in the business sector. Some charities have gone into liquidation or receivership; some have simply terminated when their grant has been cut. But there are other reasons why the issue of insolvency is important:

- The new **SORP 2 accounting requirements** impose greater reporting obligations on charities. This means that the state of the organisation's financial health will become that much more apparent to those reading the accounts. If you are unable to disguise a financial problem, you will find it that much harder to raise the money you need, thereby compounding the problem.
- The **1993 Charities Act** focuses on the responsibilities of charity trustees. Trustees faced with dwindling assets and growing liabilities will be concerned to do something about it. If the charity is an unincorporated body, then any encounter with insolvency will impose personal liabilities on the trustees to make good any deficit. If the charity is incorporated, under the Companies Act, the directors may

lay themselves open to personal liability if they continue to operate whilst knowingly insolvent. Mere expectation that things will come right eventually may not be sufficient.

- The **changing funding patterns** of many charities create additional risks. For many, and this applies most of all to local service-providing voluntary organisations once funded wholly or very substantially from one large local authority grant, there is now a diversity of funding sources, growing competition for the readily available sources of funds, and more emphasis on earning money by sales of services. There is not only more risk, and therefore more need to have reserves to act as a buffer; but there may be a need to invest in development or invest in marketing, spending money now to generate income in the future.
- In the event of an **insolvency**, any actions will be judged with the benefit of hindsight and on the assumption that proper financial systems were in place (in the context of legal requirements and the special nature of the organisation).

The problems of insolvency

Not only is insolvency a problem, but it creates problems for the organisation. There are three zones of insolvency, each with its own consequences:

The organisation is technically no longer solvent or has been deemed to be insolvent. At this stage, events take over and those responsible for the organisation lose control. *Chapter 1* gives a legal perspective on insolvency. *Chapter 2* describes what happens when the organisation actually is insolvent. The main lesson is to do everything you can to avoid becoming insolvent in the first place.

The organisation is a going concern for at least the next year ahead and hopefully for the longer term. Here the concern shifts to developing and implementing management and financial strategies for the organisation which will ensure its continuing robustness and sustainability. *Chapters 7-9* discuss many of the steps which can be taken to achieve this.

The organisation is in the 'grey zone' somewhere between solvency and insolvency. Here it may be technically solvent, but it may also be financially weak or have poor prospects for the medium term. The danger of insolvency is a consideration that must be taken into account. *Chapters 3-6* look at the financial position from a number of different perspectives.

- The perspective of the **accountant** (*Chapter 3*) who is responsible for auditing the charity's accounts, for providing an **audit statement** which could qualify the accounts but more usually gives them a 'clean bill of health' and for providing management advice on the financial procedure and accounting processes. The auditor has an external role to examine the accounts, ensure compliance with accounting standards,

report whether they give a true and fair picture of the financial position, and confirm the going concern status of the organisation.

- The perspective of the **financial administrator** (*Chapter 4*), the employee or volunteer responsible for supervising or doing the bookkeeping and the charity's accounts and responsible for overseeing the financial position of the organisation and notifying the chief executive (or senior staff member) and the trustees (or management committee) if there are problems ahead.
- The perspective of the **trustees** (or members of the management committee, if the organisation is not a charity) (*Chapter 5*). All trustees are responsible, but two are more responsible than the others – the treasurer who assumes a specific role for overseeing the charity's finances on behalf of the other trustees, and the chair who has the leadership role for the organisation. The trustees have two different perspectives. Their prime role is to act on behalf of the beneficiaries and to protect the charity's assets and resources for the purposes of the charity. As such they must take into account future needs and future beneficiaries. But they also have their own interests to protect – either because they are trustees of an unincorporated body and personally responsible for any liabilities it runs up, or because as directors of an incorporated body they must ensure that if they continue to trade they have the financial viability to do so.
- The perspective of the **Charity Commission** (*Chapter 6*). The Commission is responsible for supervising charities in England and Wales, for seeing that the interests of beneficiaries are kept to the fore, for ensuring that the role of trustee does not create such burdens and liabilities that people no longer put themselves forward to serve as trustees, and for maintaining the reputation of the charity sector as a whole.

Chapter 7 discusses what to do if something needs to be done in a hurry. For organisations in the grey zone, the trustees and senior staff have a critical role to play. If they act swiftly and decisively they have a chance to turn the organisation around. If they fail to act, insolvency may loom.

Actual insolvency leads to winding up and failure. Potential insolvency also creates problems which will have an adverse effect on the ability of the organisation to function:

- If shortfalls in current income are met from accumulated reserves or capital, and the shortfalls continue, then not only will there be a continuing drain on resources, but investment income derived from reserves and unspent cash balances will reduce year by year, compounding the financial difficulties.
- If so much effort is being placed on getting the organisation through the period of difficulty and so much fundraising effort in scraping together the resources to survive in the short term, then the strategic

development of the organisation and the development of its funding base for the longer term will be given a lesser priority.

- Any qualification of the 'going concern status' in the accounts will put the organisation's fundraising at risk. Some donors may not want to give to an organisation whose medium term viability appears in doubt, however good the services it is providing.
- Staff morale may decline if it appears that their jobs are at risk. They may want to spend time trying to protect their own future, rather than the organisation's.
- The personal liability of trustees in the event of failure may prompt some to resign or deter others from being drafted in to help.

When to be concerned

There are a number of different problems which can constitute insolvency. Each is different, and each will require different solutions:

- A **cash flow hole**. Expenditure is consistently exceeding income, and as resources get eaten up, the situation can only get worse.
- A **major grant failure**. Perhaps now or looming there is the prospect that a major part of the organisation's funding will be withdrawn. This can come about either as a result of an actual cut, or because a grants programme terminates or its grants criteria change so radically that it is no longer possible to apply (this happened for example with the demise of the Community Programme).
- The organisation has **negative net worth** – that is its assets do not cover its liabilities – and there is no prospect of the necessary funding appearing to cover the shortfall.
- The organisation does not have sufficient **liquid resources** available to cover its obligations. It may be asset rich, but if it cannot raise or borrow the cash needed to pay the bills, this can lead to action being taken by creditors.
- The organisation has **contingent liabilities** not backed by assets. For example, repairing obligations under a lease, or the obligations to employees consequent on their employment create contingent liabilities which must be accounted for and should be provided for.
- Wasting assets and equipment that there are not the **resources to replace**. If the organisation depends on these assets to continue providing a service, and if the assets are not being kept in a fit state, and if there are not the funds to replace the equipment at the end of its useful life, and if fundraising prospects are poor, then there will come a time when the organisation can no longer function effectively.

Organisations can become insolvent in any of these situations. If any are relevant to you now, or seen to be just around the corner, then you need to do something... now. You will usually have two jobs to do:

1. To address the **immediate problem** which may be to cut expenditure, to restructure the work, to bring in volunteers, to fundraise, to find additional users or customers, and
2. To develop a sound **long-term strategy** for operating the organisation successfully and for creating a sustainable stream of income to fund it.

PART 1

INSOLVENCY AND LIQUIDATION

SOLVENCY AND GOING CONCERN STATUS

**The legal, accounting and
financial considerations**