

Appendix 2

Cambridgeshire County Council Internal Audit visit to FH&E

Review of Financial Segregation between Not-For-Profit Organisations and Trading Subsidiaries

23rd November 2018

1. Introduction & Background:

The visit was intended to review the current arrangements at FH&E for the financial segregation of its not-for-profit organisations from its trading companies. A number of areas for improvement were identified, which are detailed below.

It is noted that FH&E are in the process of transitioning to a new accounting system, and the current Head of Finance & Funding has been in post for less than two months. Consequently the current arrangements are in a state of transition

This document was prepared with reference to the guidance document '*Trustees, Trading and Tax: How Charities May Lawfully Trade (CC35)*' published by the Charity Commission for England and Wales.¹ References to the relevant requirements of this guidance are provided in green. Two of the three not-for-profit organisations run by FH&E are registered as charities and therefore this guidance would apply; however, FACT is a Registered Society rather than a charity, and therefore may be subject to different requirements. Registered societies are subject to the requirements of the *Co-Operative and Community Benefit Societies Act (2014)*. If HMRC has agreed to charitable recognition of FACT, then the same requirements as those placed on registered charities may apply, but it is recommended that FH&E may wish to seek further professional advice in this respect.

2. Loans to trading companies:

The not-for-profit organisations (henceforth 'NFPOs') FACT, HACT and ESACT each funded the launch of their associated trading company through a capital loan. The size of these loans varied but they are of significant value, with the highest-value loan being £152,000 to the Fenland ACT Trading Company.

Currently, no loan agreements exist to cover this arrangement and no interest has been paid. The trading companies ('TCs') are repaying the loans; when payments for contracts come into the TC bank account, the money is currently being transferred to the NFPO and a record is being kept of how much has been repaid. This is currently not in line with charities financial rules and may expose the NFPOs to a tax risk, as the loan may currently be regarded by HMRC as "non-charitable expenditure". This arrangement also does not provide assurance over the segregation of finances between the not-for-profit and trading organisations, as effectively it amounts to subsidisation of the trading companies. (Ref 4.6, 4.11, 4.12)

Recommendation:

¹ <https://www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35>

Loans from charities to their trading subsidiaries may only be “for the benefit of the parent charity”. In order to ensure this is evidenced, as a matter of priority FH&E should:

- **Create formal written loan agreements** between the NPO(s) and TC(s) to cover the amounts loaned. These should cover the full amount originally loaned when the companies were set up.
- **Ensure these agreements include:** provision for repayment (i.e. a date when repayment is due), and a rate of return (i.e. repayment of interest) which reflects the level of risk. A reasonable indicator for an appropriate interest rate would be the amount that would have been charged on a comparable commercial loan from a bank. It may be appropriate to consider any security which can be given for the loan.

3. Preventing subsidisation of trading subsidiaries:

At present, the NPFOs and TCs share a number of costs and overheads. This includes shared premises, staff and equipment. These costs are currently paid by the NPFOs and no recharge is made to the TC's. The NPFOs therefore currently are subsidising costs which should be properly borne by the TC's. In order to demonstrate appropriate financial segregation between the NPFOs and TCs, and to avoid creating a tax liability for the NPFOs, the NPFOs need to charge for these costs.

Recommendation:

A **written agreement** should ideally be in place between each NPFO and TC, regarding the services provided by the charity to the subsidiary (and anything going in the other direction) and the charging policies for these services. Specific recommendations regarding individual aspects of charging are laid out below:

- **Buildings/Premises costs:** A formal lease or license should be in place for shared use of buildings. A rent or fee should be paid which is comparable for that paid for letting the property on the open market. It would be recommended that a % of costs are recharged to the trading companies based on e.g. proportional size of the organisations. (Ref 4.21)
- **Staff costs:** Staff time should be recharged to the trading company at cost (see section 4 below re: caveat if staff solely work for the trading company). (Ref 4.22)
- **Overheads:** Shared overheads should be recharged to the trading companies as appropriate. This would include things like utilities bills, but also the management tier of the organisation who will carry out work on behalf of both the NPFOs and the TCs. A basis for apportionment should be identified (for instance, for management costs it could be based on staff time). (Ref 4.22)
- **A regular process** for calculating and making these charges should be identified (i.e. monthly, quarterly etc.). Charges should be raised and paid in a timely manner, as otherwise this may constitute a form of subsidy of the trading company. Invoices for the charges should be produced, and payment for the total value of the invoice made from the TC's bank account to the NPFO bank account. This ensures an appropriate audit trail.

4. Ownership of assets and employment of staff by trading subsidiaries:

At present, it was noted that there are some members of staff who solely carry out work for the trading companies, and some vehicles which are solely used for trading company contracts.

It was also noted that, although the organisations do not currently offer their vehicles for hire to the public or other organisations, there have been some discussions at Board level about moving into this field. This could create a tax liability if this is carried out by the NFPO, as it would likely constitute non-primary purpose trading. It would therefore be preferable for any such trading to be carried out by the TC, as the tax liability is then reduced when gift aid payments are made to the NFPOs.

Recommendation:

Specific recommendations are made in line with [Ref 4.22](#) of the guidance for charities carrying out trading:

- Staff who solely carry out work for the trading subsidiary should be employed by the trading subsidiary.
- Any assets which are solely used by the trading subsidiary should be owned by the trading subsidiary.
- Alternatively, FH&E may wish to consider ensuring that this is not an issue, by ensuring that there are records in place to demonstrate that all staff and vehicles undertake a mix of commercial and non-commercial work over the course of a year.

5. Charging for vehicle hire by trading subsidiaries:

FH&E advised that the charge made for the hire of vehicles by the trading subsidiary was calculated on the basis of an average hire cost by a commercial company for various different rates of hire. The TC's also pay for fuel costs. It is not currently clear whether or not the charge made covers the costs incurred by the NFPOs in making the vehicles available for hire (e.g. vehicle maintenance, licensing, overheads, staff time etc).

Currently there is a clear formal paperwork trail showing the hiring of vehicles between FACT/HACT/ESACT. However, the same evidence is not in place for the hiring of vehicles between an NFPO and its trading company. This is calculated on a monthly basis, but no interest is raised and a charge is not made to the TC bank account. Instead the charge is recorded on the spreadsheet monitoring the debt levels of the TC as an 'increase' in debt.

Recommendation:

Further steps need to be taken to ensure that the charging for hired vehicles can appropriately demonstrate financial separation between the NFPOs and the TCs:

- **The calculation of the hire charge** should be reviewed to ensure that it can be evidenced that this covers the associated costs to the NPFO. It is recommended that this considers the total cost to FH&E of each vehicle including depreciation, maintenance, MOT etc. N.B. from the guidance provided by HMRC, it is not clear that it would be appropriate for such charging to include a profit element (see [Ref 4.22](#)), and it appears that if the charge set is in excess of the costs incurred by the NFPOs, this may open the organisation to the risk of challenge by

HMRC Charities, as this could be viewed as a receipt of trading by the charity, which may not be exempt from tax.

- **To evidence a clear financial separation** between the NFPOs and TCs, formal charging needs to be in place between the NFPO and TCs for the use of vehicles. Invoicing showing the monthly charges should be raised from the NFPO to the TC, and a payment made from the TC bank account to the NFPO bank account for the total value of the invoice.
- This should provide a clear audit trail allowing costs to be traced through the system.

6. Legal Status and Accounts of Trading Companies:

The trading organisations set up by FH&E on the 6th December 2017 have been created as private companies limited by share capital. At present, the relevant NFPOs are listed as 'Persons of Significant Control' but officers report that there is a lack of clarity regarding ownership of the shares, and that it is not clear that the NFPOs are majority shareholders in the trading companies. There are various questions around the legal status of the trading companies, and the accounting for these companies, which need further investigation:

- **Shareholders** should be identified, and it should be ensured that the relevant NFPOs are majority shareholders for these companies.
- **ESACT TC Accounts:** Ely and Soham ACT Trading Company have filed a set of dormant accounts for their financial year ending 30th June 2018.² The accounts consist of a balance sheet, showing the £100 share capital (and no other assets or liabilities), and have not been audited. These accounts do not appear to be a fair reflection of the actual financial situation of the TC at this time, as they do not report the loan made to finance the creation of Ely and Soham ACT Trading Company by ESACT. The accounts are also prepared as though the trading company were a dormant entity, which would only be appropriate if no transactions took place via the Trading Company prior to 30th June 2018, i.e. the organisation operated no contracts.
- **Consolidated Accounts:** It would be expected that normally consolidated accounts would be produced for each charity and its trading subsidiary. This does not appear to have taken place at FH&E.
- **Confirmation statement:** The Confirmation Statements for the three FH&E TCs will be due on the 5th December 2018 and will need to be completed.
- **A written agreement** that sets out the relationship between each NFPO and its TC should be put into place, including the lines of accountability and the oversight that the charity must have.
- **VAT:** Check whether the trading companies are VAT registered as this may be required.
- **There is a risk of conflicts of interest** where individuals are involved in both the subsidiary and the charity. Company directors are required to put the interests of the company first, while charity trustees are required to put the interests of the charity first. In the event of a conflict Directors of trading companies must still not be paid if they are trustees of the parent charity. There should be at least one charity trustee who is not a director in the trading company, and one trading company director who is not a charity trustee (**Ref 4.15**)

² <https://beta.companieshouse.gov.uk/company/11099521/filing-history>

7. Further areas for consideration:

Other areas FH&E are likely to wish to consider, based on the discussions held, have been highlighted below:

- **Organisational Structure:** It is understood that there has been consideration given to changing the current organisational structure of three separate NFPOs, each with its own TC, and moving to a single charitable organisation with a single trading company. Moving to this structure would significantly simplify administration and accounting for the organisations, and provide greater operational flexibility.
- **Financial procedures:** Given the complexity of the requirements around the relationship between the commercial and non-commercial organisations, it is recommended that FH&E consider adopting financial procedures which govern this relationship and consider investment, recharging, etc.
- **Segregation of bank accounts:** In some instances, there appears to be a lack of clarity around the segregation and ownership of funds in the high-interest bank accounts used, which may belong to any of the three NFPOs. This 'all in one' approach is likely to be appropriate in future if the NFPOs are merged into a single entity. However, at present there is a risk that there is a lack of clarity regarding which NFPO owns what amount of the total financial assets (and the accruing interest). There is therefore a risk that this could create issues in producing the annual accounts for each organisation, in the interim before they are combined into a single entity.
- **External Auditor:** It is understood that Thomas Quinn in St Ives are the external auditors for FH&E and have been in place since at least 2013. It is understood that FH&E are considering appointing new external auditors in light of the findings within the PKF report, and Cambridgeshire County Council would support this. The organisations are likely to benefit from appointing a new external auditor who may provide fresh insights and assistance in developing robust and transparent accounting systems.
- **Gift aid of income:** Note that company law means that trading subsidiaries may not make distributions in excess of distributable profits i.e. if the accounting profit is higher than the distributable profit then only the lower amount may be paid to the charity under Gift Aid. (Ref 4.5)
- **Business rates:** As FH&E are now operating trading companies from their premises, which were previously used exclusively for charitable objects, this may have an impact on the business rates on the premises charged by the rating authority. If FH&E can demonstrate that premises are used primarily for charitable purposes, the rating authority may continue to grant rate relief, but there is a need to ensure this has been openly addressed with the rating authority (Ref 4.14).
- **Further advice:** It is recommended that FH&E consider seeking further support from an accountant or external auditor with experience of charities accounting, as this is a specialist area (particularly in respect of the Registered Society) and we cannot offer absolute certainty over the advice in this document.