What Trustees need to know about Financial Crisis, Reserves and Solvency

What do trustees need to understand about the issues, triggers and actions required to ensure adequate working capital within their charity and avert a financial crisis?

Steve Billot, a partner in the business restructuring team at RSM Tenon, tackled the subject of financial crisis, insolvency and reserves at our recent May Forum, using the collapse of Refugee and Migrant Justice as a case study.

A practitioner and lecturer on insolvency and business turnaround, Steve has worked extensively in this area advising clients in professional practices - particularly the legal sector.

He was joined by our other guest speaker Carolyn Sims, Banking Director at Charity Bank, to discuss what actions charities can take to prevent insolvency.

Refugee and Migrant Justice – how did it all go wrong?

All attendees were asked to review copies of the financial accounts from Refugee and Migrant Justice (RMJ) for the year end 31 March 2009 and feedback their comments.

Founded in 1992, RMJ provided quality legal representation for refugees. By 2009, its income was £16.1m, mostly made up of £15.8m funds from the Legal Services Commission (LSC) through a contract for its services, with other income coming from litigation work, investment income and donations.

At this time, RMJ was the second largest recipient of legal aid in the UK. It was governed by high profile trustees and it had an excellent reputation for doing good works – highlighted by the fact that in 1995, it received a human rights award from Liberty, Justice and the Law Society for 'consistent and fearless use of the law to protect human rights and hold immigration and asylum policies up to the scrutiny of the courts'.

RMJ also had unrestricted reserves of £3.7m. So why was the charity placed in administration on 16 June 2010?

Steve highlighted several warning signs apparent in the accounts.

In the risk section, a planned reduction in legal aid funding given to the charity from LSC starting in April 09 is highlighted.

An upcoming major change in government payment policy is also noted – with payments being made for closed cases rather than by the hour.

Additionally, it noted the requirement for RMJ to tender for all LSC contract work in 2010.

Whilst all risks were significant, there is no mention of RMJ having a contingency plan to diversify income.

In the ‘future of funding’ section of the report, it even states that trustees had ‘no reason to believe we will be unsuccessful’ in their bid to win a new contract with LSC.

Yet, the impact of the reforms to legal aid and in particular the transition to payment on the completion of each case, combined with the charity’s reliance on LSC funding and failure to establish other income streams proved to be its undoing.

With some lengthy cases unpaid for up to two years, the amount owed to RMJ by the Commission escalated to £2 million, precipitating a funding crisis. On 16 June 2010, the charity was placed in administration and it did not recover.

An emergency public appeal raised £76,000 within 24 hours, but this was insufficient to rescue the charity, and donations were returned.

300 staff lost their jobs and 9,000 current clients were left without representation. Justice Secretary Kenneth Clarke refused to reverse the legal aid reforms and claimed that RMJ's collapse was not due to delayed payments, but to RMJ's failure to improve efficiency as other providers had done.

Could things have been different?

Steve stressed that this case showed the critical need for trustees to see the bigger picture, to react to policy changes, understand their financial impact and have good contingency plans in place.

Whilst RMJ may have anticipated the risks ahead, the trustees didn’t take sufficient action to mitigate against them.

Steve also emphasised the need for charities to have a really good finance director in place – RMJ had a financial controller but not a financial director.

Could you have fixed this? Steve asked the Forum Members. Would this be a role for structured finance?

Carolyn Sims explained that the lack of working capital is a big problem for organisations working on public sector contracts with organisations, such as the Department for International Development (DFID), which often pays three months in arrears. Charity Bank is helping several organisations in these circumstances by providing working capital facilities.

However, she stressed this approach doesn’t work when an organisation is funded chiefly by the government as the cost of borrowing needs to be factored in. Therefore, it wouldn’t have worked for RMJ.

She added that Charity Bank scrutinises every organisation in need of working capital to ensure there is a profitable business trading underneath and not just an organisation wanting to use working capital to 'paper over the cracks.'

Steve's advice for trustees was not to expect policy decisions to be reversed in times of austerity.

Trustees also need to make decisions and not to allow any of the personal agendas of staff distract them from key business issues. He said his experience working with lawyers has taught him that it is too easy for people to 'circle' problems and avoid decision making in order to be 'safe'. However, trustees must ask difficult questions to ensure they are really grasping the issues.

To highlight the impact of potential policy changes today, Steve discussed the new powers of the Charity Commission under the new Charities (Protection and Social Investment) Act 2016 which was introduced in March. The Commission will have new powers to:

- Publicly issue warnings to Trustees if it thinks there has been a "breach of trust or duty or other misconduct or mismanagement"
- Extend the number of criminal offences that result in automatic disqualification of Trustees
- Develop a process to see the disqualification of Trustees

Whilst the full details of these changes have not yet been confirmed by the Commission, trustees will be held more accountable and even personally liable if things go wrong – for instance any trustee on a board at an unincorporated charity could be held personally liable if a charity becomes insolvent. He urged trustees to check the details and ensure they are safe.

To close the session, The Forum's CEO, Denise Fellows thanked the speakers and reminded members that whilst attendance at meetings would continue to be free, for which we were grateful to our sponsors, priority will be given to paid-up members in the future.

Denise also highlighted that the next big event is the 'Summer Symposium' on 5th July which will focus on social investment, fundraising regulation and cyber security.

Numbers are strictly limited to 100 and priority will be given to members. The price for fee-paying members is £25 and for everyone else £45. Registration is from 1.30pm and the formal proceedings will be followed by a drinks reception until 6.30pm. To book your place please visit the event booking site