

## Industry in focus

# Meeting your responsibilities in times of financial distress

A guide for charity trustees  
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The demands and uncertainties facing charity trustees can make the role challenging.

Occasionally it may be appropriate to shift your primary responsibility from beneficiaries to creditors, especially if the charity is at risk of insolvency. How can you spot the warning signs of financial distress? What actions do you need to take? What are the risks and penalties of failing to meet your responsibilities?

In this guide for charity trustees, we look at how to navigate this changing legal landscape and maintain your vital work in supporting both communities and beneficiaries.

While your role as a trustee is normally a voluntary one, there are a number of parallels with [the responsibilities of company directors](#). You both have clear responsibilities to a range of stakeholders and can be exposed to financial and professional risk should something go wrong.

For trustees, as with directors, what is expected of you in cases of financial distress is both evolving and under an ever-increasing public spotlight.

In October 2022, a [Supreme Court judgement](#) clarified the responsibilities of directors or trustees when a company or charity may be approaching insolvency, a development that transformed the legal landscape.

What this ruling means is that if there is real and pressing risk of insolvency, your primary responsibility as a trustee **shifts from beneficiaries to creditors**. A failure to spot financial difficulties early enough could result in significant personal financial exposure should your charity be placed into an insolvency process.



## Rising financial risks

Both directors and trustees have always needed to look out for signs of financial distress and could face financial penalties if they fail to exercise their responsibilities.

But now the risk of the company or charity running into trouble is increasing. With costs rising, finance being hard to secure and the current economic situation putting pressure on income streams, challenging forces can quickly collide. We also live in a time when what would once have been seen as unprecedented events are occurring more frequently and impacting more severely. The COVID-19 pandemic is a clear case in point.

Charities are vulnerable to the adverse impacts of these combined risks. It is now more challenging to determine whether poor financial performance or pressure on liquidity is a temporary problem, or a sign of something much more serious.

## Protecting you and your charity

So how can you meet these evolving legal responsibilities and guard against the financial risks that could trigger them?

Drawing on our work with directors, we've developed this dedicated guide for trustees, highlighting the well-known and less obvious warning signs. We then set out the steps that you can take to protect both you and your organisation.

## Insolvency responsibilities

Pay close attention to the warning signs of insolvency – and recognise when responsibilities shift to creditors.

While the day-to-day running of your organisation may well be carried out by a separate management team, you and your fellow trustees still have ultimate responsibility for the charity. Both management teams and trustees have a duty to act in the interests of the charity and its beneficiaries and to protect and safeguard its assets, while acting with reasonable care and skill.

The Charity Commission has [provided guidance](#) on what trustees should consider when facing financial distress or insolvency. The key message is that if your charity finds itself in a situation where ongoing solvency is uncertain, then the trustee's responsibility moves from the beneficiaries of the charity to protection of creditors. This means that every step necessary to minimise the loss to creditors should be taken.

The Supreme Court judgement clarified that directors should act in the interest of the company's creditors when the organisation is at real risk of insolvency, rather than when insolvency is probable, imminent, or a reality.

As the actions taken by directors and trustees in the lead-up to insolvency come under ever greater scrutiny, it's especially important to avoid actions that could be seen as wrongful trading.

### Wrongful trading

“Worsening the position for creditors at a time when the directors knew, or ought to have known, that there was no longer a reasonable prospect of avoiding insolvent liquidation.

(s214 Insolvency Act 1986).

## Knowing the warning signs

In practice, the point at which liquidation becomes inevitable is far from clear cut. It is therefore important to look for early warning signs, respond accordingly and be able to justify your judgement at any given stage.

Some of these signs will be more recognisable than others. The more obvious signs will trigger immediate alarm bells.

But there are other signs – some of which could be wrongly assumed to be a symptom of inefficiency rather than a sign of greater issues. Nonetheless these signs could provide a strong indication of trouble and shouldn't be ignored. Paying attention to these indicators and acting early could give you the time you need to develop a solution that saves the organisation.

### The most obvious signs

- Unable to meet the payroll
- Frequently hitting the overdraft or loan facility limits
- Auditors cannot or will not sign off the accounts
- Cashflow forecasting suggests a fatal liquidity level
- Frequent use of reserves to meet ongoing liabilities
- Use of restricted funds to finance day-to-day activities
- Payments to HMRC are habitually late
- A bank has restricted its access to finance (by reducing its loan or overdraft facility, for example) and/or financial services (by limiting its access to credit cards and BACS)
- A significant creditor has issued a County Court Judgement (CCJ) or statutory demand
- Credit insurers are reducing or withdrawing cover.

### The less obvious signs

- A major customer or supplier has entered insolvency
- Financiers are requesting more information about financial and liquidity performance
- The relationship team at a key financier has changed
- Loss of key sources of donation or other income
- Suppliers refusing to advance further credit until arrears are paid
- The creditors' balance, and/or creditor days have increased
- Payments into the pension scheme(s) have been deferred
- Capital expenditure has been delayed
- There is an exposure to a significant contingent liability.





## What happens if you don't act now?

If your charity is incorporated as a company when it goes into an insolvency process, the insolvency practitioner will look closely at the actions of everyone who has acted as trustee over the previous three years. This includes de facto and shadow directors.

A de facto director essentially acts as a director even though they have not been formally appointed.

A shadow director directs or instructs the directors of a company. Both are considered to be directors for legal purposes.

Within many charities, leadership structures that include separate management teams and trustee boards can bring the existence of de facto and shadow directors into sharp focus.

The insolvency practitioner's findings are collated into a D Form report, which is submitted to the Insolvency Service.

Depending on the findings, an individual could be disqualified from acting as a director and/or a trustee in the future.

The insolvency practitioner also assesses whether wrongful trading has taken place. The Insolvency Act says that a director or trustee (including a de facto director or shadow director) is guilty of wrongful trading if they knew, or should have known, that the company was likely to become insolvent, but failed to take the necessary steps to minimise the losses of creditors.

There's a two-stage test of wrongful trading:

1. an objective test assesses what a competent person in the director or trustee's position should have known, and what action they should have taken.
2. A subjective test is then applied to the director or trustee's own knowledge, skills, and experience.

“

If found guilty of wrongful trading, the individual will be personally liable for the debts the company incurred.”



## What should you do if there are signs of trouble?

### 1

#### Be clear about the true state of your finances

- Make sure financial records are up-to-date.
- Prepare a detailed 13-week cashflow forecast. This will form the basis of your 'survival runway'. Financial projections need to be realistic and not overly optimistic.
- Carry out an immediate review of your cost base to highlight any areas where savings can be made and low priority activities could be discontinued.
- Further steps include drawing up a list of assets and actual and contingent liabilities. An important part of these are any expenses associated with closure such as lease obligations and severance costs.

### 2

#### Actively manage the risks

- Hold regular board meetings and make sure that accurate minutes are taken.
- Ensure your board maintains and frequently reviews a risk register.
- Engage with your bank and other stakeholders. If you are worried about how to do this, ask for advice from a restructuring professional.

### 3

#### Engage with creditors

- Develop a clear policy for paying creditors. This policy needs to be closely followed to avoid accusations of preferential treatment.
- Engage with creditors who are threatening legal action or who have issued County Court Judgements (CCJs). A lack of clear communication could result in them issuing a winding-up petition.

### 4

#### Seek specialist advice

- This may not be familiar territory, so specialist advice is essential.
- Talk to appropriately qualified financial and legal advisers who have the experience and perspective to provide support.
- If there is any risk of wrongful trading, take independent legal advice.

# We're here to help

The role of trustees in supporting charities is vital. An important part of this is recognising the warning signs of trouble ahead and making sure there is sufficient time to consider options.

Our teams are available to help and support charities in these challenging times. We have extensive experience of guiding trustees and management teams through times of crisis, and of advising them how best to protect the charity and themselves.

For more information, please get in touch.



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