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Charities Alert

Revised guidance for charity auditors

February 2018

In a nutshell

The Financial Reporting Council published Practice Note 11 (Revised) in November 2017 (“PN11”). The new, shorter, practice note is aligned with the updated International Standards on Auditing UK (“ISAs (UK)”) and gives specific charity guidance on each individual ISA (UK) in the same way as its predecessor. The guidance sets out areas where auditors are expected to challenge trustees and management; and so highlights matters where management and trustees should consider their response before the audit.

Some of the key points from the update include:

- The trustees’ annual report is considered ‘statutory other information’ for all charities not just charitable companies.
- Only revenue recognition is presumed to give rise to a significant risk in all charity audits.
- An appendix is included highlighting conditions and events that may indicate risks of material misstatement.
- The tone of the guidance on auditor’s response to risk section is changed from a list of procedures to considerations of a fuller initial risk assessment; guidance on assessing audit risks for heritage assets and grants payable has been added.
- Guidance relating to gift aid, taxable trading and data protection are included in matters to consider in relation to laws and regulations.
- The going concern guidance is updated to reflect the requirement for trustees to carry out their own assessment (SORP 2015[1] 3.14) and for auditors to assess trustees’ information and judgments, challenging, for example, the relationship with the reserves policy, or restricted and unrestricted cash flows.
- The updated guidance from the Charity Commission on reporting ‘matters of material significance’ is reflected.
- Example audit reports and engagement letter paragraphs are no longer provided.

Practice Note 11 (revised) is available at: https://frc.org.uk/getattachment/b2911d4f-fdca-44a4-957d-c4361e891661/Practice-Note-11-(Revised)-The-audit-of-charities-in-the-United-Kingdom-(Nov-2017).pdf

Background

PN11 supersedes the guidance issued by the Auditing Practices Board in March 2012 and takes into account the regulatory and other developments since that date. PN11 provides a briefing on matters relevant to charities that should be considered during the audit in relation to a number of the auditing standards. It sets out an expectation that audit staff will have a broad understanding, commensurate with their role, of the nature of the charity, its risks, governing document and regulatory environment, including the duty to report to regulators and other laws and regulations. For trustees and management it sets out expectations for areas of audit focus, risk factors and points of challenge which should help trustees and management prepare for the audit process.

The Auditor must ensure that their teams are briefed on the nature of the charity and regulatory environment

1 Accounting and Reporting by Charities: Statement of recommended practice applicable to charities preparing their accounts in accordance with the Finance reporting Standard applicable in the UK and Republic of Ireland (FRS 102) (effective 1 January 2015) (“SORP 2015”)

Trustees' annual reports must comply with the SORP to be properly prepared

The trustees' annual report – consistent information

When considering whether there is a material inconsistency in trustees' reporting, the auditor is not required to undertake further procedures if the financial statements make no similar disclosures or if the auditor has not obtained knowledge in respect of such matters in the course of the audit. However, when performing an audit PN11 considers it likely that the auditor would become aware of, for example, the steps taken by trustees to identify and management financial risks through the auditor's own risk assessment procedures and may become aware of non-financial risks. Inconsistencies can be omissions as well as misleading or incorrect statements. When considering whether the report has been prepared in accordance with applicable legal and regulatory requirements, auditors will expect trustees to have included the requirements in module 1 *Trustees' annual report* of the SORP that **must**[2] be followed in their annual reports.

The Auditor would be expected to review the risk register to understand the risks being managed by the charity

Risks (including fraud) and risk assessment

Additional charity specific fraud risk factors are given in PN11. These are consistent with the previous practice note with the exception of the addition of the fraud risk of 'diversion of grants payable'. The PN11 notes that the presumption that there are risks of fraud in revenue recognition may not always be appropriate but restricts this to some public sector bodies which are funded by central government grant-in-aid income where reporting on expenditure and outcomes is also required.

PN11 includes a new appendix to support ISA (UK) 315 *Identifying and assessing risks of material misstatement* which gives examples of conditions and events that may indicate the existence of risks of material misstatement. It is presumed for all charities that there will be a risks of material misstatement in revenue recognition. However, restricted funds and overseas operations are no longer specifically mentioned as presumed risks. Risks arising from IT are now mentioned including the requirement for auditors to consider controls over the IT environment and the assessment of any service organisations used by the charity as part of the control environment.

Risks specific to charities where PN11 includes additional guidance are: Completeness of income; restricted funds; overseas operations; heritage assets; and grants payable.

PN11 also gives additional support to ISA (UK) 330 *The auditor's responses to risk* including additional factors for the auditor to consider when assessing risk. Guidance relating to completeness of income has been extended to include:

- Tax efficient giving;
- Completeness of donation income;
- Recognition of income from third party fundraisers;
- Updated guidance on legacy recognition; and
- Understanding the terms under which funding is granted.

Whilst restricted funds and overseas operations are not mentioned specifically in relation to ISA (UK) 315, PN11 still requires the auditor to fully understand and assess risks associated with restricted funds, including disclosure, cost allocation, deficit balances and transfers. The requirement to understand and assess risks relating to overseas operations likewise has not changed. However, PN11 now includes factors that the auditor may consider when assessing risks associated with heritage assets and grants payable.

Trustees and management should expect to be able to explain how they ensure compliance with laws and regulations

Laws and regulations

In addition to those factors considered in the previous practice note the laws and regulations section now includes expanded guidance relating such areas as:

- whether any funding agreements make the charity subject to any further laws or regulations;
- the impact of tax, both VAT and direct taxation;
- charitable and non-charitable trading;
- compliance with HMRC gift aid rules;
- regulations relating to overseas grants and payments; and
- data protection.

The auditor should consider making inquiries of management and the trustees as to whether the charity is complying with the relevant parts of the legislation.

2 SORP 2015 32-35

The Trustees' assessment of going concern and an understanding of restricted and unrestricted cash flows are key for the auditor's assessment

Going concern

The trustees are responsible for assessing the charity's ability to continue as a going concern and are required to state this in their reports[3]. PN11 refers to the indicators in ISA (UK) 570 and includes a number of further charity specific indicators. These have not changed from the previous version. The auditor is required to evaluate the trustees' assessment, and consider whether the trustees have appropriately considered all information available to them in making their assessment. Such information may include serious incident reporting, response rates for mailings, compliance with grant conditions, and timing of cash flows, in particular the auditor may request trustees to analyse cash flows between restricted and unrestricted funds to demonstrate they are not drawing down on restricted funds.

Reserves policies should be considered as part of the going concern assessment

The auditor is also expected to consider the reserves policy as part of the assessment of going concern. The auditor considers the level of reserves and trustees' explanation for this level of reserves in the context of the charity's operations and business model.

The duty to report to the regulator is also emphasised, in particular when the audit report is modified or contains a section referring to a material uncertainty related to going concern.

Reporting to regulators

The charity did not engage constructively with regulators

PN11 includes a section covering the duty to report and reflects the *Matters of Material Significance Guidance*[4] which was jointly issued by the charity regulators in November 2017. PN11 has been updated based on that guide and clarifies again that 'material significance' does not have the same meaning as materiality in the context of the audit of the financial statements. The right to report where there is no statutory duty is also noted.

Next steps

These clarifications apply now and therefore charities and auditors should make sure that the accounts being prepared reflect the matters discussed.

Contacts

If you would like further, more detailed information or advice and to discuss how this will affect you, please contact your local Deloitte partner or:

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3 SORP 2015 3.14 and 3.39
4 Matters of Material Significance reportable to UK charity regulators: A guide for auditors and independent examiners – November 2017

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