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Exposure Draft:

Practice Note 11: *The audit of charities in the United Kingdom*

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# PRACTICE NOTE 11

## THE AUDIT OF CHARITIES IN THE UNITED KINGDOM

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## PREFACE

This Practice Note contains guidance on the application of auditing standards issued by the Financial Reporting Council (FRC) to the audit of financial statements of charities in the United Kingdom.

The Practice Note is intended to assist auditors in applying the requirements of, and should be read in conjunction with, International Standards on Auditing (UK) (ISAs UK), which apply to audits of financial statements for periods commencing on or after 17 June 2016. This Practice Note sets out the special considerations relating to the audit of charities which arise from individual ISAs (UK).

**The Practice Note does not, and is not intended to, provide comprehensive guidance on the audits of charities, so where no special considerations arise from a particular ISA (UK), no material is included. This Practice Note does not contain commentary on all the requirements included in the ISAs (UK) and reading it should not be seen as an alternative to reading the relevant ISAs (UK) in their entirety.**

Practice Note 11 applies to the audit of financial statements prepared in accordance with the Charities Statement of Recommended Practice (Financial Reporting Standard 102) (Charities SORP). It does not apply to the audit of charities preparing their accounts in accordance with other specialist Statements of Recommended Practice (SORPs) (e.g., charities which are registered social housing providers<sup>1</sup> or higher and further education institutions<sup>2</sup>) for which there are separate Practice Notes.

Where an audit is being performed on an entity within the Public Sector in the UK this Practice Note complements Practice Note 10 *The Audit of Financial Statements of Public Sector Bodies in the United Kingdom (Revised)*.

This Practice Note supersedes the guidance included in Practice Note 11 *The Audit of Charities in the United Kingdom (Revised)* issued by the Auditing Practices Board in March 2012, and takes account of significant regulatory and other developments affecting charities since that date.

The legal framework for charities is devolved, complex and different requirements exist depending on the charity's constitution and the type of activity it undertakes. The FRC's intention is not to provide a comprehensive commentary on all aspects of law that may apply to a charity's operations, and the Practice Note should not be used as a substitute for the auditor obtaining an understanding of the legal and regulatory framework applicable to a charity and the sector in which that charity operates.

The Practice Note is based on the legislation and regulations that have been published at [XXX 2017].

Audit exemption thresholds are established in UK legislation and an independent examination will often be permitted instead of an audit. An independent examination is significantly different from an audit and guidance on the conduct of independent examinations has been published by the charity regulators.<sup>3</sup> This Practice Note does not provide guidance on independent examinations.

In addition to the auditor's report on the financial statements, the auditor of a charity may be requested to provide additional reports in relation to grant-funded projects, giving assurance

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<sup>1</sup> Statement of Recommended Practice for Social Housing Providers.

<sup>2</sup> Statement of Recommended Practice: Accounting for Further and Higher Education.

<sup>3</sup> CCEW's CC32 – Independent Examination of Charity Accounts: Examiners' Guide and OSCR's Independent Examination: Guidance for charities and independent examiners.

on matters such as the proper use of money and costs to completion. This Practice Note does not cover such additional engagements.<sup>4</sup>

This Practice Note has been prepared with advice and assistance from staff of the Charity Commission for England and Wales (CCEW), the Office of the Scottish Charity Regulator (OSCR), and the Charity Commission for Northern Ireland (CCNI).

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<sup>4</sup> Guidance has been provided by ICAEW in AAF 1/10 – Framework document for accountants' reports on grant claims.

## LEGISLATIVE AND REGULATORY FRAMEWORK

1. The legislation relating to accounting and audit applicable to each jurisdiction in the UK is summarised in Appendix 2 of this Practice Note. The legal requirements in relation to accounting and auditing for charities in Scotland and Northern Ireland differ in some respects from those applicable in England and Wales, and it is important for the auditor to understand what legislation applies. Additionally, some charities may also be subject to other regulatory regimes, for example, registered social housing providers (registered social landlords) and higher and further education institutions.
2. The main laws that relate to a charity's accounts and audit are:
  - Charities in England and Wales: the Charities Act 2011 (2011 Act (E&W)) and, with respect to the disclosure of fundraising, the Charities (Protection and Social Investment) Act 2016.
  - All charities registered in Scotland with OSCR: the Charities and Trustee Investment (Scotland) Act 2005 (2005 Act (Scotland)).
  - Charities in Northern Ireland: the Charities Act (Northern Ireland) 2008 (2008 Act (NI)).
  - All charitable companies:<sup>5</sup> the Companies Act 2006.

### Charity regulators

3. The primary regulators for charities (which are referred to as 'the charity regulators' in this Practice Note) are:
  - England and Wales: the Charity Commission for England and Wales (CCEW).
  - Scotland: the Office of the Scottish Charity Regulator (OSCR).
  - Northern Ireland: the Charity Commission for Northern Ireland (CCNI).
4. The CCEW has powers under legislation to act for the protection of charity property where it is satisfied that there has been misconduct or mismanagement in the administration of a charity, or that it is necessary to act for the purposes of protecting the property of a charity or to secure its proper application for the purposes of the charity. These powers include:
  - Issuing directions to the trustees.
  - Issuing an official warning to charities when it considers that there has been a breach of trust or duty, or other misconduct or mismanagement in the charity.
  - Suspension of any trustee, officer, agent or employee.
  - Appointment of additional trustees.
  - Removal of a trustee, officer, agent or employee.
  - Discretionary disqualification of certain persons from being trustees in circumstances where they are judged not fit to act.
  - Freezing of property, restrictions on transactions or payments.
  - Appointment of an interim manager.

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<sup>5</sup> A charitable company is a company which is formed and registered under the Companies Act 2006 and is established for exclusively charitable purposes.

In Scotland, OSCR has similar powers under Sections 28, 31 and 34 of the 2005 Act (Scotland). In Northern Ireland, the CCNI has similar powers under Section 33 of the 2008 Act (NI).

5. Charities may be required to comply with aspects of charity law in more than one UK charity law jurisdiction. Such charities are known as 'cross border' charities.<sup>6</sup>
6. Of relevance to a charity's accounts and audit is UK tax law. Organisations in the UK which are awarded charitable status may qualify for specific tax exemptions and reliefs on income and gains, and on profits from some activities. A charity must be registered with HMRC to be recognised as a charity for tax purposes. This is separate from being registered with the CCEW, OSCR or the CCNI. Recognition as a charity for tax purposes does not mean that a charity will never pay tax. If a charity receives taxable (non-exempt) income or gains it must inform HMRC and complete a tax return.
7. Charities also qualify for certain Value-Added Tax (VAT) tax reliefs and exemptions. However, if a charity has business activities the VAT rules will apply as they do for any other business. In addition, charities are affected by the whole range of national legislation applicable to business entities, such as employment, tax and pensions law and health and safety regulations.

#### *Reporting direct to charity regulators*

8. In addition to the primary objective of reporting on financial statements, the auditor of a charity may have an additional statutory duty to report in certain circumstances to the relevant charity regulator.<sup>7</sup>

#### **Charity governing documents**

9. The governing documents of charities establish the purpose and constitution of each charity. They may also require an audit to be undertaken (which may supplement, but not derogate from, a statutory requirement for an audit). There is no such thing as a standard charity; the governing documents of each charity are individual and will need careful consideration to identify matters relevant to the audit such as particular charitable objects and any special powers conferred on the trustees.
10. The terms of charities' governing documents tend to be narrower than those for commercial entities, the objects of which are usually very generally phrased. This means that the auditor is much more likely to be faced with a situation where a charity has acted ultra vires (i.e., beyond the charity's powers) or in breach of trust than would be the case with an entity in the commercial sector.
11. Any transaction by a charity that is undertaken outside its objects and powers is potentially a breach of trust. Such transactions require consideration during an audit. Non-compliance with the governing documents is also likely to have financial implications for the charity, and thus needs to be considered in determining whether the financial statements give a 'true and fair' view. In addition, such transactions may give rise to a need to report the matter to the charity regulator.

#### **Accounting and auditing requirements**

12. The financial statements of a charity which are prepared to give a 'true and fair' view under the requirements of the relevant Charities Acts are required to be prepared in

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<sup>6</sup> Appendix 2 of this Practice Note provides a summary of current requirements.

<sup>7</sup> See Sections *ISA (UK) 250* and *Reporting matters of material significance to charity regulators* of this Practice Note.

accordance with UK Generally Accepted Accounting Practice (UK GAAP).<sup>8</sup> Additionally, charitable companies comply with company legislation which requires accounts to be prepared in accordance with applicable laws and regulations, and UK accounting standards.

13. UK GAAP comprises law and accounting standards issued by the FRC. Charities cannot apply International Financial Reporting Standards. Smaller charities preparing 'true and fair' accounts are now required to apply the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS 102).
14. The Charities SORP) is an interpretation of UK accounting standards for the charity sector and is intended to apply to the accounts of all charities in the UK required to give a 'true and fair' view (unless a separate specialist SORP exists for a class of charity). The Charities SORP is issued by the CCEW and OSCR as the joint SORP-making body for charities designated by the FRC.
15. Apart from any requirement for audit in the governing document, the statutory requirement for audit depends on the size of the charity, as defined in relevant legislation or regulations.<sup>9</sup> For charitable companies, the interaction between the thresholds established in the Companies Act 2006 and charity law applicable in each jurisdiction needs to be considered.
16. Several non-departmental public bodies (NDPBs) are charities. The auditor of such bodies is responsible for expressing an opinion on both the view given by the body's financial statements and on whether the expenditure of the body is in accordance with the purposes intended by Parliament.<sup>10</sup> Furthermore, for some bodies where the auditor is appointed by the Secretary of State, there may be a requirement in the auditor's terms of engagement for it to report to the sponsor department any significant matters arising out of the audit, including losses incurred owing to failures of internal control, misconduct, fraud or other irregularity.

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<sup>8</sup> Trustees of small non-company charities in England and Wales, Scotland and Northern Ireland which are within the income thresholds defined by legislation may elect to prepare financial statements on a receipts and payments basis. Financial statements prepared on a receipts and payments basis are not required to give a 'true and fair' view, but to be properly presented.

<sup>9</sup> Audit exemption thresholds are described in Appendix 2 of this Practice Note.

<sup>10</sup> Practice Note 10 (Revised) provides guidance for auditors of public bodies on reporting on the regularity of expenditure.



## **THE AUDIT OF FINANCIAL STATEMENTS**

**ISAs (UK) apply to the conduct of all audits. This includes audits of the financial statements of charities. The purpose of the following paragraphs is to identify the special considerations arising from the application of certain requirements to the audit of charities, and to suggest ways in which these can be addressed. This Practice Note does not contain commentary on all of the requirements included in the ISAs (UK) and reading it should not be seen as an alternative to reading the relevant ISAs (UK) in their entirety. Where no special considerations arise from a particular ISA (UK), no material is included.**

## **ISA (UK) 210: AGREEING THE TERMS OF AUDIT ENGAGEMENTS**

ISA (UK) 210 (Revised June 2016) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance.

### **Agreement on audit engagement terms (Ref: Para. 9–10)**

17. Under UK legislation, the trustees are responsible for the preparation of the financial statements and therefore the auditor agrees the terms of the audit engagement with the trustees of the charity and addresses the letter of engagement to the trustees.
18. Matters that will normally be included in an engagement letter for a charity are:
  - The legislative framework under which the financial statements are prepared and the audit is conducted.<sup>11</sup>
  - The statutory duty to report to the charity regulators any matters of which the auditor becomes aware that may be of material significance to the respective regulators.
  - Access to information relevant to the preparation of the charity's financial statements, recognising that not all charities are constituted as limited companies (for which the auditor's rights of access are enshrined in company law).
19. Relevant information normally includes minutes of trustees' meetings and correspondence with the charity regulators.
20. Trustees may issue other reports to stakeholders in addition to the annual report required by statute. For example, the charity may provide summary reports and financial statements, and periodic newsletters. Where this is the case, the engagement letter also sets out the auditor's responsibilities, if any, in respect of such other reports.
21. It is the responsibility of the trustees to identify the need for any additional reports required by funders and to instruct the auditor accordingly. It will not be practicable for the auditor to check the documentation relating to all funds received by the charity to identify any conditions requiring special reports. However, the auditor may consider it appropriate to enquire of the trustees whether any reports are required in addition to the auditor's report on the charity's financial statements. Separate engagement letters should be issued for non-audit work undertaken on behalf of the charity or its trustees.

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<sup>11</sup> Scottish charity law requires the auditor to consider the Trustees Annual Report and to state whether or not the report meets the requirements of the regulations and an opinion, where the auditor has formed one, that there is a material inconsistency between the annual report and the rest of the statement of account. Although there is some legal uncertainty, the Scottish Government has given a provisional view that the Annual Report is outside the scope of the "true and fair" view, and have said that they will clarify the legislation on this point when a suitable legislative vehicle is available.

## **ISA (UK) 220: QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS**

**ISA (UK) 220 deals with the specific responsibilities of the auditor regarding quality control procedure for an audit of financial statements.**

### **Relevant ethical requirements (Ref: Para. 9–10)**

22. The auditor of a charity must comply with the requirements of the Ethical Standard (2016) *Integrity, Objectivity and Independence* issued by the FRC (Ethical Standard). Within the Ethical Standard there are some specific considerations that it might be helpful for an auditor to undertake:
- Considering the self-interest risk posed by auditing a charity may need to be broader than a purely financial interest. The auditor needs to take account of any relationships between covered persons in the engagement team, connected persons and close family members and the charity which may pose a threat to independence.
  - Considering the self-review risk where a firm has provided a charity with advice or other pro bono support, which may then form part of the material covered by the audit of the financial statements.
  - Considering whether other relationships exist between a firm and a charity – although the existence of a business relationship is unlikely, if a firm made regular donations or provided material support to a charity, either financially or by allowing a material donation in kind this may be considered to be another relationship as defined in the Ethical Standard, and would impact on the auditor's independence.
  - Ensuring that a covered person in the firm does not act in a trustee capacity for a charitable trust where:
    - The relevant person is a potential beneficiary of the trust;
    - The trust holds a financial interest in an entity audited by the firm which is material to it;
    - The trust can exercise significant influence over an audited entity of the firm or its affiliates; and
    - The relevant person can influence the investment decisions of the trust.
23. The Ethical Standard includes certain additional requirements or prohibitions that apply to the audits of public interest entities and listed companies.<sup>12</sup> The Ethical Standard establishes that a firm's policies and procedures will set out the circumstances in which these additional requirements or prohibitions apply to the audits of other entities (which may include some charities), taking into consideration the nature of the entity's business, its size, the number of its employees and the range of its stakeholders.

### **Assignment of engagement teams (Ref: Para. 14)**

24. Audits of charities required by legislation in the UK may only be carried out by a registered auditor, or other persons authorised by statute or to whom, in England and Wales, CCEW may grant dispensation.<sup>13</sup>
25. Before commencing the audit of a charity, the engagement partner ensures that the firm has enough staff who have adequate knowledge and experience of such audits. Staff

<sup>12</sup> Ethical Standard, Part B, *Section 1 – General Requirements and Guidance*, paragraphs 1.48–1.50.

<sup>13</sup> The dispensation arises where a charity is audited under another statutory regime which is considered sufficiently similar to the audit requirements of the 2011 Act (E&W) or audited under arrangements which are sufficiently similar. CCEW can also give a dispensation from audit under the 2011 Act (E&W) in exceptional circumstances allowing an independent examination in place of an audit.

involved in an audit of a charity will have a broad understanding, commensurate with the individual's roles and responsibilities in the audit process, of:

- The type of charity being audited.
  - Key risks affecting the charity.
  - The applicable legislative framework, including charity accounting and audit regulations.
  - The principles of FRS 102 and the Charities SORP.
  - The charity's governing documents, which may also include specific reporting requirements.
  - The legal responsibilities and duties of charity trustees.
  - The regulatory framework within which charities operate to identify situations which may give them reasonable cause to believe that a matter must be reported to a charity regulator. This would include the charity regulators' guidance on reporting matters of material significance and other relevant charity regulators' guidance.
26. The auditor's responsibilities in this respect are not related to the level of fee charged for the audit. For example, the same levels of rigour are required in respect of audits carried out on an pro bono basis as for audits carried out for a commercial fee and the engagement partner has a responsibility for being satisfied and able to demonstrate that the audit engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the audit in accordance with all applicable Auditing and Ethical Standards.<sup>14</sup>

#### **Engagement Quality Control Review (Ref: Para. 19)**

27. International Standard on Quality Control (UK) (ISQC (UK)) 1 (Revised June 2016)<sup>15</sup> requires firms to establish policies and procedures which set out criteria to determine whether engagement quality control reviews shall be performed for other entities. ISQC (UK) 1 notes that one of the criteria that a firm considers when determining whether to require completion of an engagement quality control review includes the nature of the engagement, including the extent to which it involves a matter of public interest.<sup>16</sup> What is a matter of public interest can be difficult to define: factors that may apply to a charity include:
- The size of the charity.
  - The charity's national or local profile.
  - The charity's sources of funds (including the extent to which the charity receives public funds).
28. Where safeguards include the review by an engagement quality control reviewer, that reviewer will have sufficient knowledge of the charity sector and the applicable regulatory framework to enable a meaningful review to be completed.

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<sup>14</sup> Ethical Standard, Part B, *Section 4 – Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation*, paragraphs 4.1 and 4.2.

<sup>15</sup> ISQC (UK) 1 (Revised June 2016) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 35(b).

<sup>16</sup> ISQC (UK) 1 (Revised June 2016), paragraph A41.

## **ISA (UK) 240: THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS**

ISA (UK) 240 (Revised June 2016) deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

### **Responsibility for the prevention and detection of fraud (Ref: Para. 4)**

29. The trustees of a charity are responsible for the prevention and detection of fraud in relation to the charity, even if they have delegated some of their executive functions to senior staff. The trustees are expected to safeguard charity assets and reserves through the implementation of appropriate systems of control. The auditor of a charity is responsible for forming an opinion as to whether financial statements show a true and fair view and to this end the auditor plans, performs and evaluates the audit in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from error or fraud.
30. Many charities receive funds which have restrictions placed upon them. These funds are held on trust and must be applied to the purpose for which they were given. The misappropriation or misapplication of funds constitutes a breach of trust, whether it was intentional or accidental. In planning, performing and evaluating the audit work the auditor considers the risk of material misstatement arising from breaches of trust.

### **Evaluation of fraud risk factors (Ref: Para. 24)**

31. A list of fraud risk factors is contained in ISA (UK) 240 (Revised June 2016).<sup>17</sup> Additional charity specific factors may include:
  - The limited involvement of trustees in key decision making or monitoring transactions, and limited engagement with charity staff.
  - Widespread branches or operations, such as those established in response to emergency appeals in countries where there is no effective system of law and order.
  - Reliance on volunteers and staff with limited management or supervision and a lack of segregation and rotation of duties.
  - Transactions (income and expenditure) often undertaken in cash.
  - Unpredictable patterns of giving (in cash, by cheque, and through donations in kind) by members of the public, both in terms of timing and point of donation.
  - Informal banking or cash transfer methods used in areas remote from conventional banking systems.
  - Inconsistent regulation across international borders.
  - International transfer of funds.
  - Grants payable.
32. The auditor is not required to review or conclude on the adequacy of the approach taken by trustees to assess and address risks faced by the charity. However, where the trustees have produced documentation that sets out their assessment of the various risks facing the charity, and how they believe those risks are controlled and managed, the auditor has regard to that documentation (and any fraud register where maintained) when performing its own assessment of the risk of material misstatements to financial reporting resulting from fraud.

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<sup>17</sup> ISA (UK) 240 (Revised June 2016) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, Appendix 1.

## **Identification and assessment of the risks of material misstatement due to fraud**

(Ref: Para. 25–27)

33. In assessing the risk of misstatement arising from fraud, the auditor also considers the extent of the trustees' involvement in the day-to-day administration of the charity, their access to its resources and their ability, collectively or individually, to override any internal controls. Additionally, the auditor considers the arrangements the trustees have put in place to monitor work undertaken by third parties (e.g., custodianship of investments and fundraising).
34. The auditor considers the possibility that the charity's records of income to which it is legally entitled may be incomplete as a result of fraud. A common type of fraud against charities is the diversion of donations. Sources of audit evidence as to whether income from appeals and other 'non-routine' sources have been fully recorded can involve the assessment and testing of internal controls, and comparison of donations actually received by the charity to past results for similar appeals, to budgets and to statistics for response rates for charities in general. A further example is where a charity recognises income that it may never receive, for instance on the back of an informal pledge for which there is no formal agreement or payment plan, to provide assurance that the pledged monies will be forthcoming.<sup>18</sup>
35. The auditor remains aware that, although charities are not profit-making entities, there is still a risk of material misstatement due to fraudulent financial reporting relating to income recognition. This presumption may not always be appropriate for some public sector bodies which are funded from central government directly by grant-in-aid income where reporting on expenditure and outcomes is also required.

## **Communications with those charged with governance** (Ref: Para. 40–42)

36. The auditor will communicate fraud related matters to those charged with governance (i.e., the board of trustees) in all situations. Other appropriate levels of management for many charities will include the Chief Executive or equivalent.
37. All such communications are subject to 'tipping off' provisions under anti-money laundering legislation. Where there is a suspected or actual instance suggesting dishonesty or fraud involving a significant loss of or major risk to charitable funds or assets, the auditor makes a report direct to an appropriate authority outside the charity without delay, and without informing the trustees or any officers of the charity in advance if they are suspected of being involved.<sup>19</sup>
38. In the case of charities, the appropriate authorities include the National Crime Agency (NCA) where there is a suspicion of money laundering and the appropriate charity regulator.<sup>20</sup>

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<sup>18</sup> Further guidance on the completeness of income can be found in paragraphs 110–114 of this Practice Note.

<sup>19</sup> See also Section *Reporting matters of material significance to charity regulators* of this Practice Note.

<sup>20</sup> See also paragraphs 58–59 of this Practice Note.

## **ISA (UK) 250: SECTION A – CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS**

ISA (UK) 250 (Revised June 2016) deals with the auditor's responsibility to consider the laws and regulations in an audit of financial statements.

### **Responsibility for compliance with laws and regulations (Ref: Para. 3)**

39. The trustees of a charity are responsible for ensuring that the necessary controls are in place to ensure compliance with applicable laws and regulations, and to detect and correct any breaches that have occurred, even if they have delegated some of their executive functions to professional staff or advisers.

### **The auditor's consideration of compliance with laws and regulations (Ref: Para. 12)**

40. In the case of charities, the legal and regulatory framework includes charity and trust law, and hence specific requirements as to the use of restricted funds and preservation of any permanent endowments (capital funds).
41. The legal and regulatory framework specific to charities is summarised in Appendix 2. In addition, charities are affected by the whole range of national legislation applicable to business entities, such as employment, tax and pensions law and health and safety regulations.

### *Laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements*

42. Laws and regulations which have a direct effect on the determination of material amounts and disclosures in the financial statements for unincorporated charities are contained in the relevant legislation and subordinate regulations<sup>21</sup> relating to the particular UK jurisdiction in which the charity operates. Where individual charities are subject to legislation other than specific charity legislation there may be certain additional disclosure requirements (e.g., charitable companies or charitable housing associations).
43. The auditor also checks whether a charity's governing documents contain any special provisions as to the disclosure of information in the financial statements or reporting requirements for the auditor. Users of the financial statements of a charity reasonably expect that the transactions recorded within them are authorised by the governing documents of the charity and in furtherance of the charity's objects. In order to give a true and fair view, due regard needs to be given to disclosure of any significant non-compliance with the governing documents. The governing document may, for example, take the form of a trust deed, a will, a constitution or the Articles of Association of a company.
44. The auditor therefore obtains an understanding of the charity's governing documents and in planning and conducting the audit:
- Ensures that the audit procedures cover compliance with the governing documents.
  - Considers any changes in the charity's activities to ensure that these comply with the governing documents.
  - Is alert to new or unusual transactions which may not be in accordance with the governing documents.
45. Charities may receive financial assistance from government or other entities (e.g., grants, loans and loan guarantees). By accepting such assistance, charities often

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<sup>21</sup> See Appendix 2 of this Practice Note.

become subject to laws and regulations that may have a direct and material effect on the determination of amounts in the charity's financial statements. Such laws and regulations may specifically address:

- The types of goods or services that charities may purchase with the financial assistance.
- The eligibility of those to whom charities may provide benefits.
- Amounts charities must contribute from their own resources toward projects for which financial assistance is provided.
- Principles and standards for determining the direct and indirect costs that are allowable as charges to such financial assistance programmes.

*Laws and regulations where instances of non-compliance may have a material effect on the financial statements*

46. Determination of those laws and regulations where instances of non-compliance may have a material effect on the financial statements of a particular charity requires consideration of its governing documents, the activities it undertakes and any laws and regulations specifically applicable to those activities, as well as the requirements of charity law. To assist in identifying possible or actual instances of non-compliance with these laws and regulations, the auditor inspects any recent correspondence between the charity and the relevant charity regulator in accordance with the provisions of the ISA (UK).
47. The auditor will therefore also consider the impact of that particular activity on the overall ability of the charity to operate effectively in terms of the charity's current objectives. Where a particular activity, whilst subject to laws and regulations, does not have a material effect on the financial statements of a charity then the auditor has no responsibility for considering whether such laws and regulations have been observed.

*Charity tax and trading income*

48. Failure to comply with tax laws and regulations may have either direct and material effect on the determination of financial statement amounts (e.g., the result of an incorrect accrual for VAT) or a material indirect effect on the financial statements that would require appropriate disclosures (e.g., a charity's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures).
49. Whilst charities do not enjoy a general exemption from direct taxation, there are significant tax exemptions available to charities both in relation to income and chargeable gains, as well as certain indirect taxes. The auditor needs to have an understanding of these statutory exemptions and extra-statutory concessions in order to identify activities that may fall outside their scope. Especially where income is receivable that does not fall within such reliefs, a charity can be exposed to significant tax liabilities.
50. Gift aid is an important source of income for many charities, and trustees need to ensure that the charity is complying with the strict rules set out by HMRC for its proper operation. In particular, the completeness of documentation and audit trails, and any transactions with, or benefits passing to, the donor or connected persons will need careful consideration. HMRC may consider the implications for gift aid where a charity's activities are not fulfilling the public benefit test, or where the trustees do not meet the "fit and proper persons" test.<sup>22</sup>

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<sup>22</sup> This requirement was introduced by Section 30 and Schedule 6 of Finance Act 2010. HMRC have issued detailed guidance on how HMRC applies this test.



51. Charities which make grants or payments overseas run a greater risk of their payments being deemed non-charitable by HMRC and therefore need to pay particular attention to the HMRC guidance on the steps that HMRC expect organisations to take in order to be able to demonstrate that they have undertaken sufficient due diligence on such payments.<sup>23</sup>
52. The existence of trading activities can affect the charity's compliance with laws and regulations, potential tax liabilities and, in some cases, can give rise to matters to be reported to the relevant charity regulator. Trading by charities falls into two main categories:
  - Primary purpose trading (also known as charitable trading) which is generally exempt from direct taxation; and
  - Trading to raise funds for charitable purposes, which is generally not exempt from direct taxation, unless the trade falls within the exemptions available for small trades or the concessions made for charity fundraising events.
53. Primary purpose trading is the exercise of a trade in the course of the actual carrying out of a primary purpose of a charity (e.g., the charging of fees by a school which is established as a charity for the advancement of education). The tax exemption available on primary purpose trading also extends to trades where the work is mainly carried out by the beneficiaries of the charity and the remedial or educational value of the work to the beneficiaries can be demonstrated.
54. Charitable trading may also extend beyond primary purpose activities to incorporate 'ancillary trading'. Ancillary trading, which contributes indirectly to the successful furtherance of the purposes of the charity, is treated as part of 'primary purpose trading' for both charity law and tax purposes. An example of ancillary trading is the sale of food and drink in a restaurant or bar by a theatre charity to members of an audience.
55. Trading for fundraising purposes and other non-charitable trading activities, where undertaken directly by a charity on a substantial or regular basis, may be contrary to charity law and the profits may be liable to income or corporation tax.
56. Substantial permanent trading for fundraising purposes would also be incompatible with charitable status, and generally such trades would be hived off to a wholly-owned subsidiary company which might in turn agree to covenant back any profits to its charitable parent. A failure to apply such income or gains for charitable purposes only can result in loss of tax relief. The impact of a tax assessment, perhaps going back a number of years, may affect a charity's ability to continue to conduct its activities.
57. Charities enjoy no general exemption from VAT, which can apply to a range of goods and services supplied in the course of business. Certain primary purpose trading activities as well as trading for fundraising purposes can fall within the meaning of business activity for VAT purposes. Many areas in which charities operate, such as the supply of certain educational, health and welfare services, may be exempt from VAT, and a number of special reliefs also apply specifically to charities.<sup>24</sup> Non-compliance or errors could have adverse financial consequences for the charity.

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<sup>23</sup> HMRC's guidance can be found here: <https://www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-ii-non-charitable-expenditure#payments-to-overseas-bodies>

<sup>24</sup> A number of specific exemptions and zero-rating treatments may be available in relation to supplies by and to a charity.

### *Money laundering*

58. Auditors in the UK have reporting obligations under Anti-Money Laundering Legislation<sup>25</sup> to report knowledge or suspicion of money laundering offences, including those arising from fraud and thefts, to the National Crime Agency (NCA).
59. Any knowledge or suspicions of involvement of a charity's trustees in money laundering would normally be regarded as being of material significance to the charity regulators and so give rise to a statutory duty to report in addition to making any necessary report required by legislation relating to money laundering offences. Reporting a matter to NCA does not relieve the auditor of a duty to report that matter to charity regulators where the information is of material significance to the regulator's function.

### **Communicating identified or suspected non-compliance with those charged with governance** (Ref: Para. 23–25)

60. The auditor is required to communicate the auditor's findings to the appropriate level of those charged with governance (in the case of a charity, the trustees), unless the auditor concludes that the suspected or actual instance of non-compliance ought to be reported to an appropriate authority outside the charity and that it no longer has confidence in the trustees. In this case, the auditor makes a report direct to an appropriate authority, without delay and without informing the trustees in advance.
61. In those cases where the trustees are not involved in the day-to-day management of the charity, having delegated this function to staff, and it is the latter who are suspected of involvement in the breach of laws or regulations, the auditor may consider that it is appropriate to communicate with the trustees in the first instance.

### **Potential implications of identified or suspected non-compliance for the auditor's report on the financial statements** (Ref: Para. 26–28)

62. The auditor's report on a non-company charity's financial statements is usually addressed to its trustees. Although an actual or suspected breach of relevant laws or regulations may already have been reported to the trustees as managers of the charity, the auditor's report on the financial statements is nevertheless required to include details of any material uncertainty, or disagreement over disclosure of a suspected or actual instance of non-compliance having a material effect on the financial statements.

### **Reporting identified or suspected non-compliance to an appropriate authority outside the charity** (Ref: Para. 29)

63. Where the auditor identifies or suspects non-compliance with laws or regulations, the auditor considers whether such a matter should be reported to an appropriate authority outside the charity, including whether the matter should be reported to the charity regulators.<sup>26</sup>

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<sup>25</sup> Guidance on the auditor's responsibilities regarding the Anti-Money Laundering Legislation is set out in Practice Note 12 (Revised) *Money laundering – Guidance for Auditors in the United Kingdom*.

<sup>26</sup> See Section *Reporting matters of material significance to charity regulators* of this Practice Note.

## **ISA (UK) 260: COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE**

ISA (UK) 260 (Revised June 2016) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

### **Those charged with governance** (Ref: Para. 11)

64. Those charged with governance are normally the board of trustees (who are also the directors in the case of a charitable company). Where there are subcommittees of the board, (e.g., an audit committee) the sub-committee may fulfil this role. The auditor's understanding of the charity's governance structure and processes obtained in accordance with ISA (UK) 315 (Revised June 2016)<sup>27</sup> will be relevant in determining with whom the auditor should communicate. The appropriate person(s) with whom to communicate may also vary depending on the matter to be communicated, for example, it may be appropriate in some circumstances to communicate minor housekeeping matters only to the executive.
65. Where the trustees employ staff to whom certain executive functions are delegated, the auditor will still report to those trustees who are charged with governance, since such executive powers are delegated from the trustee body.

### **Establishing the communication process** (Ref: Para. 18)

66. The auditor considers whether any of the matters communicated with those charged with governance should also be reported to the charity regulators as required by the auditor's statutory duty in this regard.<sup>28</sup>
67. The auditor also considers whether there are any matters communicated with those charged with governance that, whilst they do not appear to be of material significance to the charity regulators, the auditor nevertheless believes, in the auditor's professional judgment, that the matter is likely to be relevant, or of interest to the charity regulators (e.g., where trustees have failed repeatedly to take corrective action, without reasonable cause, to address deficiencies in internal control). In such cases, the auditor may exercise its right to report to the appropriate charity regulator.<sup>29</sup>

### **Adequacy of the communication process** (Ref: Para. 22)

68. Charity trustees are usually unpaid<sup>30</sup> and part-time, and governance structures can be very varied. In planning the audit, the auditor needs to understand the nature of the charity's governance and the influence that this has on the control environment of the charity<sup>31</sup> and on reporting to those charged with governance.
69. ISA (UK) 260 (Revised June 2016) stresses that communication shall be active, two-way communication between the auditor and those charged with governance. Because charity trustees represent a wider range of skills and experience than may be found in the commercial sector, the auditor particularly ensures that the auditor's communications are understandable and clear.

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<sup>27</sup> ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*.

<sup>28</sup> See Section *Reporting matters of material significance to charity regulators* of this Practice Note.

<sup>29</sup> See paragraph 262 of this Practice Note.

<sup>30</sup> A charity trustee may only be paid where this is in the interests of the charity and provides a significant and clear advantage over other options. There is no power in law to make such payments – it would need to be specifically authorised in the governing documents of the charity, or approved by a charity regulator or a court.

<sup>31</sup> See Section *ISA (UK) 315* of this Practice Note.

## **ISA (UK) 265: COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT**

ISA (UK) 265 deals with the auditor's responsibilities to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

### **Communication of significant deficiencies in internal control (Ref: Para. 9–10)**

70. Trustees have a legal duty to manage the charity's resources responsibly and the charity regulators issue general guidance for trustees on implementing appropriate financial controls.<sup>32</sup> Such guidance may help the auditor to identify those areas where there may be deficiencies in internal control.
71. Significant deficiencies in internal control may call into question the integrity or competence of management. In these situations, the auditor considers the need to make a report of matters of material significance to one or more of the charity regulators.<sup>33</sup>

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<sup>32</sup> For example, CCEW's [Internal financial controls for charities \(CC8\)](#).

<sup>33</sup> See Section *Reporting matters of material significance to charity regulators* of this Practice Note.

## **ISA (UK) 315: IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

ISA (UK) 315 (Revised June 2016) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

### **Inquiries of management and others within the entity** (Ref: Para. 6(a))

72. The auditor inquires of management and, where appropriate, those charged with governance as to whether the trustees have made a report to a charity regulator.<sup>34</sup>

### **The relevant regulatory framework** (Ref: Para. 11(a))

73. The legal framework for charities is complex, and different requirements exist depending on the charity's constitution, the part of the UK in which the charity is established and the type of activity which it undertakes. The auditor needs to obtain an understanding of the applicable laws and regulations of the jurisdiction within which the charity operates. This involves keeping up to date with laws and regulations relating to charities generally, and to the audited charity in particular. The list of such laws and regulations is likely to be extensive and far reaching and needs to be carefully discussed with the charity to ensure that they are identified in full. These may include areas such as employment, health and safety, social care, tax, financial, fundraising regulation.
74. The accounting requirements under which charities report depend on how they are constituted and the relevant national jurisdiction within the UK.<sup>35</sup> The auditor should have an understanding of the Charities SORP, which sits alongside UK Generally Accepted Practice (FRS 102). The auditor should also be familiar with the relevant Charities Acts.
75. A charity may also have activities outside of the UK. As such, the auditor also needs to obtain an understanding of the applicable laws and regulations relating to the charity's activities in jurisdictions outside of the UK.

### **The nature of the entity** (Ref: Para. 11(b))

76. Knowledge of the charity's activities, governance, operating structure, sources of income and the existence of restricted funds is essential for assessing the risk of material misstatement arising from fraud, error, or non-compliance with applicable laws and regulations and in order to plan and carry out the audit effectively and efficiently.

### *Governance*

77. Although the detail of regulation differs between different jurisdictions in the UK, the general principles governing the duties of trustees are the same regardless of what they are called in the charity's governing documents.<sup>36</sup>
78. Auditors can find further information regarding the responsibilities of trustees and charity governance from the relevant Charities Acts, or the charity regulators.<sup>37</sup> The charity sector has its own voluntary code of governance.<sup>38</sup>

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<sup>34</sup> In England and Wales, this is known as a serious incident report; in Scotland, there is a non-statutory notifiable events regime.

<sup>35</sup> The principal categories are set out in Appendix 2 of this Practice Note.

<sup>36</sup> Charity trustees are defined in legislation as "the persons having the general control and management of the administration of a charity".

<sup>37</sup> For example, see CCEW's *The essential trustee: what you need to know, what you need to do* (CC3).

<sup>38</sup> Good Governance: a Code for the Voluntary and Community Sector' which was published in October 2010

79. Charity trustees are usually unpaid<sup>39</sup> and part-time, and governance structures can be very varied. In planning the audit, the auditor needs to understand the nature of the charity's governance and the influence that this has on the control environment of the charity and on reporting to those charged with governance (see ISA (UK) 260 (Revised June 2016)).<sup>40</sup> The auditor also needs to obtain an understanding of any policy for the payment of trustee expenses to ensure it is disclosed correctly in the financial statements in accordance with the Charities SORP.
80. The auditor also needs to understand the charity's governing documents. There are many different types of governing instrument or constitution which will determine the objects of the charity and the powers of its trustees, and the audit approach needs to be adapted accordingly. Particular issues include:
- Any limitations in objectives placed on the charity by its governing documents.
  - Terms and restrictions placed on material gifts or donations received.

#### **Selection and application of accounting policies** (Ref: Para. 11(c))

81. The auditor reviews accounting policies and considers the application of the Charities SORP. Accounting policies adopted may have a significant effect on the recognition of assets and liabilities or their presentation within financial statements. Policies that may require careful consideration may include those for the classes of transactions, accounts balances and disclosures included in Appendix 1 of this Practice Note.
82. For group audits, the auditor also considers the consistency of accounting policies between the charity and other entities.
83. The auditor considers what steps have been taken by trustees and senior management in respect of cost allocations. Policies that affect the allocation of costs may have a significant impact on how costs are presented in the statement of financial activities.

#### **Measurement and review of financial performance** (Ref: Para. 11(e))

84. The auditor also considers the key performance indicators used to monitor the performance of the charity especially those used by the trustees.

#### **Internal control** (Ref: Para. 12–13)

85. There is a wide variation between different charities in terms of size, activity and organisation. Smaller charities may be administered by volunteer staff or by third party administrators. Larger charities may directly employ professionally qualified, full-time staff. However, the responsibilities of trustees for ensuring that the charity has adequate internal controls and therefore is properly administered and its assets properly safeguarded apply irrespective of a charity's size or administrative arrangements, and the attitude, role and involvement of each charity's trustees are likely to be fundamental in determining the effectiveness of its control environment.
86. The maintenance of an effective system of internal control is at least as important, if not more so, for charities as it is for other entities, since it is a fundamental duty of charity trustees to protect the property of their charity and to secure its application for the objects of the charity. Failure to do so can render the trustees personally liable for any loss occasioned to the charity. The auditor of certain charities may be subject to specific reporting requirements in respect of internal controls (e.g., registered friendly societies, registered social landlords and charitable NDPBs). Where there is such a requirement, the auditor plans the auditor's work bearing in mind the need to report if a satisfactory system of control over transactions has not been maintained.

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<sup>39</sup> See Footnote 30 of this Practice Note.

<sup>40</sup> See Section *ISA (UK) 260* of this Practice Note.

### **Control environment** (Ref: Para. 14)

87. The role, attitude and actions of the trustees are fundamental in shaping the control environment of a charity.
88. As part of the audit risk assessment, the auditor should assess the charity's governance structure and associated control environment. This would include consideration of the skills of trustees and management and the extent of trustee involvement in the governance of the charity. For small charities this may include understanding how the segregation of duties risk is mitigated.

### **The charity's risk assessment process** (Ref: Para. 15)

89. The Charities SORP requires larger charities to include in the Trustees' Annual Report a description of the principal risks and uncertainties facing the charity and its subsidiary undertakings, as identified by the charity trustees, together with a summary of their plans and strategies for managing those risks. As a result of this, charities will often maintain a risk register as part of a wider risk management process. The auditor would be expected to review this register in order to gain an understanding of the risks currently being managed by the charity and whether any of these could lead to a material misstatement risk for financial reporting.

### **Information systems and related business processes** (Ref: Para. 18)

90. For charities it is particularly important that the systems in place are able to capture accurately any restrictions placed on income (whether imposed by the donor or as a result of the charity's fundraising initiatives). The charity also needs to ensure the documentation supporting the restrictions on the income is retained and easily accessible. This includes any deeds of covenant.

### **Control activities relevant to the audit** (Ref: Para. 20)

91. Some of the control activities which are special to charities are set out in guidance issued by CCEW – 'Internal Financial Controls for Charities'.

### **Risks arising from IT** (Ref: Para. 21)

92. The auditor should consider as part of the audit risk assessment those IT systems managed by the charity, including those outside of/interacting with the central finance system that could lead to an audit risk. For example, this may include systems holding donor information, legacy records, patient/beneficiary information, and gift aid data.
93. Many charities have websites which provide facilities for online giving. These may support a donation by credit card, sponsorship or legacy making. Charities will often use third party organisations to manage these systems and processes. The auditor needs to consider whether adequate controls exist over the IT supporting these systems including the assessment of any service organisations used by the charity as part of this control environment.<sup>41</sup>
94. As well as considering the risk of material misstatement associated with all systems identified, the auditor should also consider the disclosure risk where these systems are expected to be used by the charity to support non-financial disclosures within the annual report.
95. Where the charity operates outside of the UK, the auditor should also consider the information systems in those jurisdictions as they relate to the entity being audited.

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<sup>41</sup> See Section *ISA (UK) 402* of this Practice Note.

### **Identifying and assessing the risks of material misstatement (Ref: Para. 25)**

96. There is a wide variation between different charities in terms of size, activity and organisation, so that there can be no standard approach to internal controls and risk. The auditor assesses risk and the adequacy of controls in relation to the circumstances of each charity.
97. Appendix 1 of this Practice Note includes examples of events or conditions that may be of particular relevance to charities and may indicate the existence of risks of material misstatement in the financial statements. These examples are in addition to the broad range of events and conditions included in the ISAs (UK).<sup>42</sup>
98. Overseas activities may give rise to additional risks. In these circumstances the auditor will need to ensure that it is able to assess the full extent of the activities, and have the necessary understanding of the regulatory environment in which significant activities are carried out (e.g., in relation to taxation and employment law).<sup>43</sup>

### **Risks that require special audit consideration (Ref: Para. 27–29)**

99. Issues concerning revenue recognition are likely to give rise to significant risks affecting all charity audits.<sup>44</sup>

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<sup>42</sup> See: ISA (UK) 315 (Revised June 2016), Appendix 2; ISA (UK) 570 (Revised June 2016), paragraph A3; and ISA (UK) 600 (Revised June 2016), Appendix 3.

<sup>43</sup> The Charity Commission has issued guidance on charities working internationally.

<sup>44</sup> Further guidance on the audit procedures in respect of these risks can be found in Section *ISA (UK) 330* of this Practice Note.



## **ISA (UK) 320: MATERIALITY IN PLANNING AND PERFORMING AN AUDIT**

ISA (UK) 320 (Revised June 2016) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

### **Determining materiality when planning the audit (Ref: Para. 10)**

100. Judgments about materiality are affected by the auditor's perception of the financial information needs of users of the charity's financial statements. In most cases, this is the trustees, but it is not limited to the trustees. For example, if the charity is funded by grants, the auditor may also consider the information needs of the grant provider when making an assessment of materiality.
101. For a charity, materiality for the financial statements as a whole is often assessed as a percentage of income, expenditure, or net assets. Unlike many commercial entities, charities are not profit-driven and therefore it is relatively rare to use net result for the year as a sole benchmark when determining materiality.
102. ISA (UK) 320 (Revised June 2016) indicates that materiality is considered at both the overall financial statement level and, in certain circumstances of the charity, in relation to individual account balances, classes of transactions and disclosures. This can result in different materiality considerations being applied depending on the item of the accounts being considered, for example, the degree of accuracy expected in the case of certain disclosures, (e.g., transactions with trustees are likely to be considered to be material by nature, even if they are not material by size)<sup>45</sup>. Also particular disclosures or expenditure categories may be sensitive and warrant extra attention (e.g., costs of raising funds or overseas transactions).

### *Branches<sup>46</sup>*

103. The auditor clarifies with management which entities will form part of the financial statements being produced by the charity. Where a charity operates through branches or subsidiaries, their contribution to the results and financial position of the charity may not be known at the time of planning the audit. In this case, the auditor considers how to decide the likely results of branches or subsidiaries by reference to procedures such as:

- Discussion with management.
- Consideration of problems or particular issues encountered in previous years to see whether there is an identifiable pattern suggestive of weak management or fraud.
- Consideration of prior year figures and any budgeted or preliminary results.

The resulting best estimate is incorporated into the materiality calculation for the financial statements as a whole.

### *Restricted funds*

104. Many charities receive funds subject to specific trusts, which must be accounted for separately (unless grouped together if, individually, they are comparatively small) in accordance with the Charities SORP. There is no presumption that the auditor will set a different monetary materiality level for such funds.

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<sup>45</sup> Module 9 of the Charities SORP states that transactions with trustees or related parties are always regarded as material regardless of size.

<sup>46</sup> For further guidance on group financial statements see Section *ISA (UK) 600* of this Practice Note.

105. The ISA (UK) provides guidance<sup>47</sup> on the factors that may indicate that lesser amounts than materiality could reasonably be expected to influence the economic decisions of users and which may result in different materiality considerations being applied to particular classes of transactions, account balances, or disclosures in the financial statements.
106. Any breaches of the terms of trusts relating to restricted funds which come to the auditor's attention in the course of its work, regardless of materiality to the financial statements as a whole, need to be considered in terms of their significance to the auditor's report on the financial statements and brought to the attention of trustees, as a failure on the trustees' part to comply with the terms of trusts may place them in breach of their responsibilities.
107. The auditor also considers the disclosure of restricted funds which are subject to specific trusts as to their application, paying particular attention to:
- Any funds that are in deficit.
  - Any income funds which are held in illiquid assets (including inter-fund loans) thereby preventing application of the fund.
  - Any expenditure of the capital of a permanently endowed fund.

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<sup>47</sup> ISA (UK) 320 (Revised June 2016), paragraph A10.

## **ISA (UK) 330: THE AUDITOR'S RESPONSES TO ASSESSED RISKS**

ISA (UK) 330 (Revised June 2016) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in an audit of financial statements.

### **Risks common to charities**

108. The auditor should always perform a full risk assessment to identify risks of material misstatement arising in the specific context of the charity. Appendix 1 of this Practice Note provides a list of conditions and events that the auditor may wish to consider when identifying and assessing risks of material misstatement in the financial statements.
109. In addition to the guidance in this Section, the auditor may wish to consult other Sections of this Practice Note in relation to the following areas:
  - Unusual business models (see Section *ISA (UK) 315*).
  - Significant estimates (see Section *ISA (UK) 540*).
  - Related parties (see Section *ISA (UK) 550*).
  - Going concern (see Section *ISA (UK) 570*).

### **Completeness of income**

110. Whilst it is the trustees' responsibility to safeguard the assets and income of the charity, the voluntary nature of some elements of its income may restrict the methods available to the trustees to ensure that all income to which the charity is entitled is correctly accounted for.
111. The amount of voluntary income cannot, in many cases, be determined in advance, nor can a charity be regarded as necessarily entitled to funds, even when the amounts have been pledged, before the charity is in receipt of them. Trustees of a charity cannot be held responsible for the security of money or other assets which are intended for its use until that money or assets are, or should be, within the control of the charity. Trustees should, however, establish procedures to ensure appropriate recording and safeguarding as soon as such assets come within their control.
112. The auditor considers the following factors when assessing the risks associated with the completeness of income and how to address any identified risks:
  - Mechanisms used for cash donations: donations may be made tax-effectively, through gift aid, payroll giving, and gifts of land and shares. For most tax effective schemes, and especially for gift aid, there are detailed requirements relating to the procedures to be followed by donors and recipient charities, as well as detailed rules designed to prevent abuse (for instance the reciprocal benefit limits). The auditor considers the implications of the significance of these income streams and adapts the audit procedures accordingly.
  - Completeness of donation income: the completeness of recorded donation income can be difficult to substantiate as such income will not always be supported by invoices or equivalent documentation. Where cash donations are received, the trustees need to make arrangements to institute appropriate controls, to the extent practicable, to ensure that all income is properly accounted for. The auditor may consider the effectiveness of such controls when assessing the sufficiency of evidence about the completeness of the income shown in the charity's financial statements.
  - Recognition of income from third party fund-raisers: income recognition can be a complex issue where a charity obtains resources by means of fundraising

organisations.<sup>48</sup> The auditor considers the agreement (between the charity and the fundraiser) and other documents relating to the transaction to see whether all donations received in the charity's name have been transmitted to it or otherwise accounted for and that amounts have been accounted for gross where appropriate instead of having been netted off at source.

- Recognition of income from branches, associates or subsidiaries: if charities use branches, associates or subsidiaries to raise funds, the auditor considers the arrangements made by the main charity to determine at what point income is recognised.
- Recognition of legacy income: the recognition criteria for legacy income may be met when the charity becomes aware of the legacy and once the executor(s) of the estate have established that there are sufficient assets in the estate, after settling liabilities, to pay legacy income. Evidence that the executors have determined that a payment can be made may arise on the agreement of the estate accounts or some other notification that the payment will be made. Notification may in some circumstances be received after the year end which demonstrates that the executor(s) clearly agreed prior to the year-end that legacy income can be paid. The probability and measurability of the receipt may be affected by subsequent events such as valuations and disputes. The auditor therefore reviews information available up to when the accounts are approved for evidence relating to legacy income receivable at the balance sheet date. Sources of audit evidence as to whether legacy income has been correctly recorded include probate information, estate accounts, correspondence from executors or solicitors, and legacy fundraising agencies. With charities that receive legacy income, it is possible for them to be able to subscribe to agencies that will notify them on any will where probate is granted where the charity is a named beneficiary. Such notifications can help the auditor in relation to testing for legacy completeness. The auditor needs to understand the terms attached to legacies in order to consider the application of the charity's income recognition policies. The auditor must also give consideration to the valuation of donations in kind where appropriate.
- Informal fundraising groups: where informal fundraising groups raise money or other resources for charitable purposes on a voluntary basis, without the knowledge of any particular charity, criteria for recognising income are not met until the funds raised are notified to the recipient charity. In general, neither trustees nor the auditor has an obligation to estimate the extent of income from such sources before this point. Even if a legal entitlement on the part of the charity to the resulting income may arise under trust law, it would normally be inappropriate for the charity to account for income from such sources. This is because its ultimate cash realisation cannot be sufficiently determined by the charity.
- Grants or contractual income: in the case of grant or contractually funded charities, an examination of the grant applications or contract and correspondence can assist in confirming completeness of income. The auditor considers obtaining direct confirmation of the amounts receivable from the grant provider. The auditor must also have an understanding of the terms under which the funding is granted in order to identify the proper accounting treatment, As well as distinguishing whether the income is restricted or not, the nature of the terms and conditions may affect taxation considerations (e.g., VAT treatment).

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<sup>48</sup> The Charities Act 1992 Section 59 (as amended by the Charities (Protection and Social Investment) Act 2016) requires there to be an agreement between the charity and the fundraiser in a prescribed form.

- Non-cash donations: charities often receive non-cash donations. The auditor must carry out sufficient appropriate audit procedures to gain assurance over the completeness of such items. Such procedures may include internet research to identify relevant material publicising such donations.
113. Analytical procedures may be used as a source of audit evidence about the completeness of income. For example, the use of a substantive analytical procedure may be appropriate to gain assurance over a charity's trading income. However, the degree of inherent uncertainty affecting donated income restricts the reliance which can be placed on such techniques in respect of donations.
114. In the case of larger charities with more complex operations, there are specialist publications and sources of information which can be referred to for general information about charities as well as comparative figures and statistics. These sources include 'trade' journals, umbrella organisations, and the charity regulators. Available statistics include responses to mail shots (i.e., donations received), and industry norms such as sales per square foot for trading operations in different areas.

### **Restricted funds**

115. Restricted funds are subject to specific trusts, which may be declared by the donor or created through legal process. They may be restricted income funds (which are expendable at the discretion of the trustees in furtherance of some particular aspect of the objects of the charity) or they may be endowments (where the assets are required or permitted to be invested or retained for future use). If restricted funds are used other than in the way specified, the trustees of the charity will have breached their duty.
116. The Charities SORP indicates that restricted funds are to be separately disclosed in the charity's financial statements.
117. Restricted funds (including endowments) which are subject to specific trusts as to their application may give rise to a significant risk of misstatement.
118. The auditor may consider the following factors when assessing the risks associated with restricted funds and how to address any identified risks:
- Identification and disclosure of restrictions on funds: the auditor considers whether restrictions are likely to exist as part of the planning process and when assessing the presentation of funds in a charity's balance sheet. The auditor should assess the design and implementation of the internal control procedures put in place by the charity to identify restricted funds (whether imposed by the donor or as a result of the charity's fund raising initiatives).
  - Cost allocation: grants are often made for specific purposes and are subject to conditions, breach of which can have serious implications for the charity. There is a risk that the charity may inappropriately allocate costs between funds, potentially resulting in the misuse of a restricted fund. The auditor should assess the procedures used by the charity in allocating costs to ensure that expenditure charged to restricted funds is appropriate.
  - Consideration of future funding to cover negative balances.
  - Inappropriate transfers between funds: the auditor should determine the validity of any transfers between funds.
  - Use of the capital element of a permanent endowment without express authority: where such a situation is identified the auditor should consider the auditor's obligations under ISA (UK) 250 (Revised June 2016) and whether the auditor has a duty to report to the charity regulators.

## Overseas operations

119. Overseas activities can be undertaken through a number of different structures including branches, joint ventures with other charities, projects managed by local agents or partners through to the grant funding of autonomous local organisations. The auditor of a charity is responsible for forming an opinion on the financial statements reflecting all of the charity's operations, wherever they are situated and however they are constituted.
120. The auditor may perform the following procedures when performing a risk assessment on a charity with overseas operations:
- Obtain an understanding of how trustees control overseas operations. Management procedures may involve the vetting of applications, reviewing project reports received, setting thresholds for site visits to projects involving significant grant funding, confirmation of grant receipts, reviewing accounts and the local certification of expenditure.
  - Obtain evidence from field officers' reports as to work undertaken.
  - Comparison of accounting returns of expenditure with field reports and plans for consistency and reasonableness.
  - Analytical review of accounting returns received from overseas branches or local agents.
  - Review of any inspection or internal control visit reports undertaken by any internal audit function.
  - Review of audit work undertaken by local auditors, and review of any audit reports carried out on behalf of international donors (e.g., government departments).
  - Review of evidence from the audit work of another auditor.
121. Common audit risks identified in overseas operations associated with charities include:
- Completeness and disclosure of material assets held or material funds applied by overseas branches or subsidiaries: the auditor may seek observational evidence by way of site visits. Such visits may provide valuable evidence of the existence of tangible fixed assets and of project work being undertaken by the charity. The auditor needs to be aware of the logistical arrangements which may be needed where site visits to remote areas are considered.
  - Appropriateness of the charity's oversight mechanisms over the use of funds by autonomous overseas organisations: where a charity makes a significant grant to an overseas organisation that is autonomous from the charity, the auditor seeks evidence to support receipt of funding by that organisation, and assess whether the charity has exercised reasonable diligence in ensuring application of the funds for the purposes of the charity's objects.
  - Timing of recognition of expenditure within a complex overseas charity structure: where the overseas operations are part of the charity, the transfer of funds by itself does not give rise to expenditure as such funds remain under the control of the charity. However, the auditor must obtain an understanding of the structure of the charity to determine at what point expenditure is incurred, and obtain audit evidence to support material expenditure in the field.
122. In some cases it may be more cost effective to engage component auditors to undertake audit work on overseas operations. In such situations the requirements of ISA (UK) 600 (Revised June 2016) on group financial statements will apply.<sup>49</sup>

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<sup>49</sup> See Section *ISA (UK) 600* of this Practice Note.

## Heritage assets

123. The auditor may consider the following factors when assessing the risks associated with heritage assets<sup>50</sup> and how to address any identified risks:

- Sufficiency of information available to the entity to obtain a valuation of the heritage asset: in forming a judgment on whether sufficient information is available to obtain an accurate valuation of a heritage asset the auditor may consider the valuation of comparable assets, the availability and cost of experts in the field and the degree of specialisation of the asset. If additional information on valuation becomes available at a later date the auditor should reconsider the appropriateness of the judgment made.<sup>51</sup>
- Completeness of heritage assets: the auditor should review the charity's internal control mechanisms used to manage the heritage asset portfolio and perform searches to identify any high profile donations or purchases made during the period.

## Grants payable

124. Many charities carry out their activities through a combination of direct service provision and the grant funding of third parties to undertake work that contributes to the charity's aims or programme of work.

125. Where charities make grant payments to third parties, the auditor may consider the following factors when assessing audit risk and how to address any identified risks:

- Oversight of those charged with governance: the auditor should consider how those charged with governance monitor the charity's grants. For example, a list of grants paid and payable may be shared with those charged with governance, and the charity may have specific procedures in place to manage the formal approval process of recipients. The auditor should assess the design and implementation of the internal control procedures put in place by the charity to allocate and oversee its grants.
- Diversion of grants to inappropriate recipients: the auditor may choose to circularise the recipients of grants to ensure no funds have been diverted. The auditor may also review any acknowledgement returns or "thank you" letters received by the charity from grant recipients. The auditor should apply professional scepticism when considering the validity of such returns as audit evidence.

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<sup>50</sup> For charities that are public bodies (NDPBs) Chapter 7 of the Government Financial Reporting Manual (FRM) applies.

<sup>51</sup> If significant accounting estimates are involved in respect of the valuation of heritage assets the auditor should refer to Section *ISA (UK) 540* of this Practice Note.

## **ISA (UK) 402: AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION**

ISA (UK) 402 deals with the auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

### **Obtaining an understanding of the services provided by service organisations**

(Ref: Para. 9)

126. The auditor of a charity needs to consider the nature and extent of activity undertaken by service organisations to determine whether those activities are relevant to the audit, and what their effect is on audit risk.
127. Use of a service organisation does not diminish the ultimate responsibility of the trustees for conducting the affairs of the charity in a manner which meets their legal responsibilities, including those of safeguarding the assets, maintaining accounting records and preparing financial statements. Similarly, a charity's use of a service organisation does not alter the auditor's responsibilities when reporting on the charity's financial statements.
128. Common use of service organisations within the charity sector include:
  - Maintenance of accounting records.
  - Payroll services.
  - Fundraising and donor fulfilment.
  - Custodianship of assets, and investment management services.
129. It is not uncommon for charities to share an accounting function. In such cases the auditor considers the control arrangements for allocation of costs between such connected entities.
130. Some charities choose to partner with commercial fundraising organisations in order to generate income. However, the legal rules that apply to various types of fundraising can be detailed and complex. Guidance on fundraising has been issued by the charity regulators.<sup>52</sup>
131. Where investment management arrangements exist, the auditor considers how trustees set investment objectives and monitor performance. The auditor also discusses with the trustees how they ensure that the level of delegation is consistent with the charity's powers and that the investment powers are being properly exercised.
132. Practice Note 15 (Revised)<sup>53</sup> sets out guidance on the auditor's considerations and sources of audit evidence in circumstances where investment management and custody functions are outsourced. This guidance may also be relevant to certain charity audits.
133. Certain arrangements may also involve a service organisation providing facilities and services direct to a charity's beneficiaries. Examples include:
  - Management of a recreational facility such as a sports centre, provision of services to beneficiaries such as the management of a care facility.
  - Provision of ancillary catering facilities (e.g., a museum restaurant).
134. The charity's governing documents may set out powers for the trustees to delegate activities to outside service organisations, who may not be charities themselves. The auditor reviews such documents where practicable, or alternatively holds discussions

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<sup>52</sup> As well as the websites of the charity regulators, see guidance issued by the [Fundraising Regulator](#).

<sup>53</sup> Practice Note 15 (Revised) *The audit of occupational pension schemes in the United Kingdom*, paragraphs 245–247.



with the trustees, to determine whether there is authority, or presumed authority, for outsourcing. In doing so, the auditor should consider whether any outsourced arrangements provide a risk of a conflict of interest existing between a trustee or senior employee of a charity and the outsourcing provider, and consider how these should be addressed by audit procedures.

135. Where the charity's controls in relation to service organisations are poor or absent, the auditor also considers whether the status of the charity's internal control arrangements should be the subject of a report to the relevant charity regulator.

## **ISA (UK) 510: INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES**

ISA (UK) 510 (Revised June 2016) deals with the auditor's responsibilities relating to opening balances in an initial audit engagement.

### **Nature and extent of audit procedures on opening balances (Ref: Para. 6)**

136. Special considerations will apply where a non-company charity changes its basis of accounting from a receipts and payments to an accruals basis, or where the financial statements become subject to an audit, having previously been subject to a report by an independent examiner.
137. When there has been a change in the basis of accounting procedures may include checking bank statements, the review of receipts and payments after the year end, and a physical check of any tangible fixed assets. For analytical procedures performed in the current year the auditor is likely to need to adjust the prior year management information prepared on a receipts and payments basis to enable a proper comparison.
138. If the prior year's financial statements were audited by a predecessor auditor, the auditor takes into account the professional competence and independence of the other auditor (e.g., whether the predecessor auditor is a charity specialist) in determining whether reviewing the predecessor's auditor's working papers provides sufficient appropriate audit evidence regarding the opening balances.
139. Predecessor auditors of a charitable company have a statutory duty to provide the auditor with access to all relevant information concerning the charitable company,<sup>54</sup> including information concerning the most recent audit. Where there is no such statutory obligation, as is the case for unincorporated charities, the auditor may nevertheless request access to the predecessor auditor's working papers. In some circumstances, the predecessor auditor may be prepared to consider granting such access. Where such access is refused, the auditor performs alternative procedures in order to obtain sufficient appropriate audit evidence regarding the opening balances.

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<sup>54</sup> ISQC (UK) 1 (Revised June 2016), *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*, paragraph 28D-1.

## **ISA (UK) 540: AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES**

ISA (UK) 540 (Revised June 2016) deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements.

### **Obtaining an understanding of the requirements of the applicable financial reporting framework** (Ref: Para. 8(a))

140. Common areas of charity financial statements which are affected by accounting estimates or fair value adjustments are included in Appendix 1 of this Practice Note.
141. The Charities SORP provides detailed guidance on appropriate accounting policies and measurement bases. In applying these policies and bases the use of estimates and estimation techniques will be necessary to determine the monetary value of assets and liabilities and to determine the allocation of costs within the SoFA– such as support cost allocation. In order to comply with FRS 102 and the Charities SORP, a charity's financial statements discloses a description of the estimation techniques adopted, including underlying principles, that are significant.

### **Obtaining an understanding of how management makes the accounting estimates** (Ref: Para. 8(c))

142. The Charities SORP allows certain valuations to be undertaken by trustees or employees of a charity, provided that, in the case of property valuations, they have knowledge of the relevant property market. In this situation, the auditor assesses the individual's relevant experience in accordance with the requirements of ISA (UK) 500<sup>55</sup> and the associated guidance in relation to a management's expert.
143. The requirement to discount will give rise to the need to assess that the discount rate applied is appropriate. The Charities SORP gives some guidance on rates that should be used- such as for legacies receivable using the interest rate for the charity over a similar period and for provisions it is the rate which reflects the cost of money to the charity – which may need to consider other factors such as the return on investments foregone. Therefore a charity which only receives interest may use an interest rate as a discount factor whereas a charity invested in stocks and shares could use the rate of return on those assets instead – which would mean that these two rates could vary considerably.
144. Evidence relating to cost allocations across the cost categories of the SoFA may sometimes be obtained through observation, for example, by observing the key duties of staff and internal departments to determine whether staff costs are reasonably allocated between the categories of charitable expenditure and the costs of generating funds. Where material estimates are required to allocate joint costs between the expenditure categories of the SoFA, the auditor needs to consider whether the accounting policies adequately explain the estimation techniques adopted.
145. Where expenditure by a charity relates to a project which is of uncertain duration, because it is subject to external circumstances beyond the control of the trustees, it may be difficult to determine matters such as the expected useful economic life of fixed assets used in the project (e.g., vehicles or other capital equipment used to provide emergency aid in a war zone may have an uncertain future, or the trustees may consider that the economic costs of redeploying equipment exceed its book value). The auditor uses its knowledge of the charity's activities and accounting policies to assess whether the periods for write-down of fixed assets are reasonable and in line with any estimate of service potential.

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<sup>55</sup> ISA (UK) 500, *Audit Evidence*, paragraph 8.

146. On occasion evidence obtained from post balance sheet review and observation may be insufficiently conclusive. Where such estimates are likely to be material the auditor reviews the process by which the estimate was arrived at and considers the basis of the calculation in terms of its reasonableness, justifiability and consistency. In so doing, the auditor will draw heavily on its knowledge of the charity in testing the consistency of principles adopted. Estimates of this nature may include:

- The quantification of future charitable commitments and constructive liabilities.
- Valuations of gifts in kind received, particularly property.
- Valuation of assets received for onward distribution.
- Valuation of fixed asset investments where no market price exists, (e.g., unlisted securities and trading subsidiaries of the parent charity).
- Valuation of heritage assets.
- Valuation of intangible income derived from donated services or use of facilities.
- Estimates of on-going service potential of fixed assets, in the absence of a cash flow, in an impairment review.
- Impairment of programme-related investments made in furtherance of a charity's objectives, rather than for financial return.
- Recoverability of loans made to beneficiaries in the furtherance of a charity's objects.

**Indicators of possible management bias** (Ref: Para. 21)

147. In the charity sector management may be biased in their accounting estimates in order to achieve certain results for the year although bonuses based on results are not common. A management bias may arise from:

- A desire to meet trustee expectations on the results for the year.
- A desire to demonstrate growth.
- A need to meet covenant obligations attached to bank loans.
- Wanting to avoid repayments of grant funds if they are not fully utilised.

Management bias may also extend to those charged with governance.

## **ISA (UK) 550: RELATED PARTIES**

ISA (UK) 550 deals with the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements.

### **Understanding the charity's related party relationships and transactions**

(Ref: Para. 12–14)

148. ISA (UK) 550<sup>56</sup> notes that many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances. The charity sector has such a framework. The charity regulators have identified conflict of interest as a major factor in many of their inquiries and the auditor therefore obtains sufficient appropriate audit evidence relating to the identification, accounting, and disclosures of related party transactions, recognising that charities have a specific definition of the term.
149. Related parties is a term used by the Charities SORP that combines the requirements of charity law, company law and the Financial Reporting Standard applicable in the UK. Related parties include a charity's trustees and their close family members and those entities which they control or in which they have a significant interest. In considering a possible related party relationship, a charity assesses the substance of the relationship and not merely its legal form.
150. A transaction involving a trustee or other related party is always considered material by nature, regardless of its size.

### **The charity's controls over related party relationships and transactions** (Ref: Para. 14)

151. The charity regulators issue guidance on the relevant controls they expect management to put in place to authorise and approve significant related party transactions. The auditor has regard to this guidance, and forms an assessment of the controls necessary to arrive at proper disclosure.
152. In making inquiries of management, the auditor addresses both the trustees and the senior management team where such a team has delegated powers. This team will generally be the same as those disclosed within the Annual Report and captured in the aggregate remuneration disclosure.

### **Maintaining alertness for related party information when reviewing records or documents** (Ref: Para. 15)

153. In addition to those records or documents that normally may indicate the existence of related party relationships or transactions, the auditor inspects whatever documentation the auditor considers necessary for indications of the existence of related parties (e.g., minutes of trustees' meetings).

### **Assertions that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction** (Ref: Para. 24)

154. Possible assertions in charity financial statements relate to:
- Trustees exceptionally taking on paid senior management team roles.
  - Services or goods being bought from a related party due to a lack of available suppliers in the general market.
  - Loans and gifts either to or from trustees.

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<sup>56</sup> ISA (UK) 550, paragraph 3.

The auditor obtains comfort on assertions relating to exchange transactions by assessing the rigour of the process the charity has gone through prior to approving these transactions. Such a process may include the following:

- Comparison to market indices.
- Consideration of alternative sources of expertise (e.g., by obtaining alternative quotations).
- Paying due attention to the sections of the relevant Charities Acts which allow trustees to be paid for certain services.

In addition it is a feature of charities that they conduct non exchange transactions and transactions under market value. The auditor considers these for evidence of related party transactions, noting the specific disclosure requirements of the charity regulators.

**Written representations** (Ref: Para. 26)

155. Because the charity financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance.

## **ISA (UK) 570: GOING CONCERN**

ISA (UK) 570 (Revised June 2016) deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

### **Going concern basis of accounting** (Ref: Para. 2)

156. Charity financial statements are usually prepared on a going concern basis of accounting, which assumes that the charity will continue its activities for the foreseeable future, unless the trustees either intend to liquidate or cease operating, or there is no realistic alternative but to liquidate or to cease activities.
157. The Charities SORP reiterates the relevance of this concept in the preparation of charity financial statements which are intended to show a true and fair view. Accounting standards require trustees, when preparing financial statements, to make an assessment of the charity's ability to continue as a going concern. Where material uncertainties related to events or conditions cast significant doubt on the charity's ability to continue as a going concern have been identified, FRS 102 requires disclosure of those uncertainties in the financial statements.
158. The Charities SORP also requires that where there are no material uncertainties about the charity's ability to continue as a going concern, the financial statements should state this.<sup>57</sup>

### **Trustees' responsibility for assessment of the charity's ability to continue as a going concern** (Ref: Para. 3–5)

159. It is essential that the trustees make their own assessment of the charity's ability to continue as a going concern, as required by the Charities SORP,<sup>58</sup> to assure themselves of the validity of the going concern basis of accounting assumption when preparing the financial statements.<sup>59</sup>

### **Events or conditions that may cast significant doubt in the charity's ability to continue as a going concern** (Ref: Para. 10–11)

160. The examples of indicators contained in the ISA (UK)<sup>60</sup> apply as much to charities as to commercial entities and include pointers such as an excess of current liabilities over current assets. Charity specific indicators include:
- Inability to finance its operations from its own resources or unrestricted funds.
  - Transfer to, or takeover by, another entity of the charity's activities.
  - Deficits on unrestricted funds.
  - Loss of clients (e.g., where a public authority ends a practice or contract to refer (and pay for) clients to the charity).
  - Loss of operating licence (e.g., for a residential care home).
  - Significant changes in strategy of major funders, and significant decline in donations by the public.
  - Investigation by a charity regulator.
  - Claw-back of grant received and gift-aid refunds.

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<sup>57</sup> Paragraph 3.39 of the Charities SORP.

<sup>58</sup> Paragraph 3.14 of the Charities SORP.

<sup>59</sup> It may be useful for the auditor to ensure that the trustees are aware of the guidance issued by the Charity Commission [Managing a charity's finances: planning, managing difficulties and insolvency](#) (CC12)

<sup>60</sup> ISA (UK) 570 (Revised June 2016), *Going Concern*, paragraph A3.

- Reliance on major donors.
- Failure to meet reserves policy targets.
- Persistent failure to meet the requirement for public benefit, leading to withdrawal of funding or tax liabilities.

Where a charity fails to meet the public benefit requirement either in whole or in part, the auditor also considers the implication of actions taken, or likely to be taken, by the regulator, and assesses the implications on the auditor's opinion.

161. The auditor has no duty to assess whether the charity's activities are for the public benefit in order to establish that the charity is a going concern. However, persistent failure by a charity to meet its public benefit requirement may have an implication for the auditor's assessment of going concern.

**Evaluating the trustees' assessment** (Ref: Para. 12)

162. The Charities SORP requires the trustees to take into account all available information about the future when making their assessment of the charity's ability to continue as a going concern.<sup>61</sup> When evaluating the trustees' assessment, the auditor inquires as to what information is available about the future to the trustees (e.g., serious incident reporting or response rates for mailings) and considers whether the trustees have appropriately considered such information in making their assessment.
163. In considering factors relating to a charity's status as a going concern, it is necessary to take account of the particular circumstances of that charity which may affect its ability to continue its activities. Charities vary considerably in how they are funded and therefore the auditor considers the availability of future funding and whether uncertainties over that funding exist and the liabilities and costs that the charity is required to meet. Diverse sources of income and a core of secure funding, avoiding over-dependence on any one source, may help reduce the risk of the charity not being a going concern. The charity's purpose may also require consideration: some charitable activities are focused on a specific purpose, and once this is achieved, the charity may cease to operate.

*Income*

164. Assessment of the going concern basis can be complicated by the uncertainty as to future income streams to which many charities are subject. In considering projections of income the auditor considers the income sources, their regularity and predictability and the degree of risk attaching to such sources.
165. Although the most significant factor ensuring the future viability of many charities is public goodwill, it is difficult, if not impossible, to value and cannot be included in the balance sheet, nor can the auditor rely solely on the existence of goodwill as evidence to support the going concern assumption.
166. Restrictions placed on the use of particular funds held by a charity may be relevant to the consideration of its going concern status. An understanding of unrestricted and restricted income, and capital or permanently endowed funds is relevant both in relation to the consideration of balance sheet funds held at the year end and to the impact that such restrictions may have on the understanding of future cash flows. Factors the auditor considers may include the:
- Nature and impact of the restrictions placed on the use of any material restricted income funds.
  - Liquidity of assets held within restricted income funds.

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<sup>61</sup> Paragraph 3.14 of the Charities SORP.



- Nature of the restrictions placed on expenditure of any endowed funds, the impact such restrictions have on the ability to fund planned activities, the nature of any restrictions to be placed on future appeals or other projected income.
  - Operational ability to withdraw from projects or activities which have been subject to fund designations or restrictions.
167. The auditor may request the trustees to analyse the cash flow forecasts between restricted and unrestricted funds in order to demonstrate that the charity is not drawing down on restricted funds.
168. Charities receiving grants of public funds (including lottery funds) are normally required to meet certain specified conditions. Expenditure outside grant conditions can lead to disallowance and repayment. Many charities rely on public authorities for grant support. Where the financial effect of withdrawal of funding would be fundamental to a particular charity, the auditor assesses whether compliance with grant conditions has been achieved or otherwise obtains evidence about steps taken by the trustees to ensure compliance.
169. The timing of cash flows may also be relevant for certain categories of charities. Factors that can impact on a charity's cash flows include:
- Reliance on annual votes of monies from governmental or central funding bodies, reliance on grant funding that reimburses expenditure only once incurred, or delays in the approval or payment of such funding.
  - Grant funding provided for specific projects but not for central administrative costs, or funding of long-term projects based only on short-term commitments as to funding receivable.
  - The cash flow impact of any constructive liabilities accrued in the balance sheet, or on conditions being met for any contingent grants disclosed within contingent liabilities.
  - Constructive obligations, such as grants payable or other funding commitments that are recognised as liabilities but are payable over a number of years.

### *Reserves*

170. By law, charities must spend the income they receive within a reasonable period of time on achieving their charitable purposes. However, this is balanced against the trustees' duties to manage the charity's resources responsibly, in a way that helps to mitigate financial risks the charity may be exposed to.
171. As part of the auditor's going concern assessment, the auditor considers the charity's reserves policy. The Charities SORP sets out the disclosures that must be made in respect of the charity's reserves policy, including where the trustees have decided that holding reserves is unnecessary,<sup>62</sup> and associated good practice.<sup>63</sup> Guidance for trustees explains that charities should develop a policy on reserves which establishes a level of reserves that is right for the charity and clearly explains to its stakeholders why holding those reserves is necessary.<sup>64</sup>
172. The auditor considers the level of reserves and the justification for this level of reserves in the context of the charity's operations and business model.

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<sup>62</sup> Paragraph 1.22 of the Charities SORP.

<sup>63</sup> Paragraph 1.48 of the Charities SORP.

<sup>64</sup> Charity reserves: building resilience (CC19) can be downloaded from:  
<https://www.gov.uk/government/publications/charities-and-reserves-cc19>

### **Additional audit procedures when events or conditions are identified (Ref: Para. 16)**

173. Where events or conditions have been identified that may cast significant doubt on the charity's ability to continue as a going concern, the auditor performs additional audit procedures to determine whether a material uncertainty exists related to those events or conditions. In addition to the audit procedures included in the ISA (UK),<sup>65</sup> the following procedures may be particularly relevant to the auditor of a charity:
- Analysing and discussing budgets, cash flow forecasts and business plans, based on past experience and the certainty of inflows and outflows.
  - Analysing and discussing any shortfall of identifiable future income on forecast expenditure needing to be made up by voluntary donations of cash or other resources.
  - Obtaining and reviewing lists of projects supported or awards made in the year and planned for the following year.
  - Analysing and discussing the level of uncommitted reserves remaining available to the charity.
  - Determining whether there is any reliance on support by the charity's bankers, major donors, or public authorities; concentration on the provision of services to a particular category of beneficiaries or objects for which future funding or demand may be limited.
174. When analysing and discussing budgets and cash flow forecasts, and business plans, the auditor considers these in the context of the auditor's understanding of the governance structure of the charity, particularly the knowledge and skills of the trustees.
175. Where the charity relies for a significant part of its funding on one or more major institutional donors or granting authorities such as local authorities, the auditor determines whether it would be practical to obtain confirmations<sup>66</sup> from such funders as to their future support for the charity. It is not unusual for granting authorities to be reluctant to confirm to a charity or its auditor that future funds will be made available, particularly where their own budgets have yet to be secured. The absence of confirmation does not, of itself, necessarily cast significant doubt upon the ability of the charity to continue as a going concern. The auditor seeks to differentiate between circumstances where the lack of a confirmation reflects the existence of a material uncertainty regarding going concern and caution on behalf of the funder that is not indicative of a material uncertainty.
176. However, if the auditor concludes that a charity's funders may be refusing to confirm funding for reasons that are specific to the charity, the auditor considers the significance of this and, where appropriate, discusses with the trustees whether there are alternative plans or sources of financing that would enable to going concern basis of accounting to continue to be adopted.
177. The events or conditions described in paragraph 160 of this Practice Note may be mitigated by the charity's ability to adopt alternative strategies that mitigate an uncertainty. For example, the effect of a charity being unable to confirm that a new grant will be received from a public authority may be counterbalanced by the trustees' plans to:
- Review the efficiency and effectiveness of operations and services.
  - Seek additional sources of funding or launch an emergency appeal.

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<sup>65</sup> ISA (UK) 570 (Revised June 2016), paragraph A16.

<sup>66</sup> ISA (UK) 505 deals with the auditor's use of external confirmation procedures to obtain audit evidence.

- Review or renegotiate commitments.
  - Review existing borrowing or loan facilities or seek new facilities.
  - Communicate with stakeholders or members who may be able to offer additional help.
  - Cut or curtail planned expenditure to try and bring the level of expenditure below the expected income.
  - Contract some of the charity's activities.
  - Sell some of the charity's fixed assets or investments.
  - Collaborate or merge with another charity or other entity.
178. Where the trustees assert that they have alternative strategies to overcome any adverse factors the auditor assesses whether the outcome of these plans are likely to improve the situation and whether they are feasible in the circumstances.
179. Where the going concern basis within a charity group involves support between entities, the auditor considers the extent to which such support is within the charitable objects and powers.

**Auditor conclusions** (Ref: Para. 20)

180. Where events or conditions have been identified that may cast significant doubt on the charity's ability to continue as a going concern, but based on the evidence obtained the trustees and the auditor have concluded that no material uncertainty exists, the auditor evaluates whether, in view of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. The following disclosures, where made,<sup>67</sup> may be of particular relevance to the auditor:
- The explanation of the material uncertainties related to events or conditions that cast significant doubt on the charity's ability to continue as a going concern or a statement that there are no material uncertainties about the charity's ability to continue as a going concern.
  - The judgments that the trustees have made in the process of applying the charity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.
  - The key assumptions concerning the future.
  - The description of the principal risks and uncertainties facing the charity and a summary of the trustees' plans and strategies for managing those risks.
181. Where the trustees do not include such disclosures in the financial statements, the auditor considers the implications for the auditor's report.

**Duty to report going concern matters to charity regulators** (Ref: Para. A34)

182. The auditor should also consider whether any of the circumstances relating to going concern require the auditor to report a matter of material significance to a UK charity regulator.<sup>68</sup> In particular, where the auditor either:
- Includes a separate section in the auditor's report entitled "Material Uncertainty Related to Going Concern"; or

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<sup>67</sup> Paragraphs 3.38-3.40 of the Charities SORP set out the matters that must be included in the financial statements and good practice

<sup>68</sup> See Section *Reporting matters of material significance to charity regulators* of this Practice Note.

- Expresses an adverse opinion where the use of the going concern basis of accounting is inappropriate in the circumstances; or
- Expresses a qualified or adverse opinion where adequate disclosure of the material uncertainty has not been made in the charity's financial statements; or
- In extremely rare circumstances, expresses a disclaimer of opinion in situations involving multiple material uncertainties that are significant to the charity's financial statements as a whole,

the auditor has a duty to report such matters to the appropriate charity regulator(s).

183. The auditor may also consider making a report to the charity regulator<sup>69</sup> before the auditor's report is issued where the auditor concludes that there is a significant risk of charity failure or a risk to charitable funds resulting from the consideration of going concern, and that swift intervention by a charity regulator may be necessary.

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<sup>69</sup> See paragraph 262 of this Practice Note.

## **ISA (UK) 580: WRITTEN REPRESENTATIONS**

ISA (UK) 580 deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance in an audit of financial statements.

### **Preparation of the financial statements (Ref: Para. 10)**

184. The trustees as a body are responsible for the contents and presentation of the financial statements. Consequently, discussion of the content of any written representation by the trustee body as a whole may be appropriate before it is signed on behalf of the trustees.
185. For charities where there are executive staff members, it is likely that in practice there are some representations that necessitate discussion with those persons. The auditor often finds it useful to attend the meeting at which trustees consider the financial statements and representation letter, to encourage discussion of significant items or matters, including unadjusted errors, arising in the course of the audit.

### **Other written representations (Ref: Para. 13)**

186. In addition to representations required by ISAs (UK), the auditor of a charity also considers obtaining written representations that:
- All income has been recorded.
  - Restricted funds have been properly applied.
  - Constructive obligations for grants have been recognised.
  - All correspondence with regulators has been made available to the auditor including, in England and Wales, any serious incident reports.
  - The trustees consider there to be appropriate controls in place to ensure overseas payments are applied for charitable purposes.
187. Timely communication by the auditor with the trustees on significant issues on which representations will be required is important in this sector, which relies primarily on voluntary trustees who are not involved in the day-to-day running of the affairs of the charity.

## **ISA (UK) 600: SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)**

ISA (UK) 600 deals with special considerations that apply to group audits, in particular those that involve component auditors.

### **Understanding the group, its component and their environment** (Ref: Para. 17–18)

188. Charities may operate through a variety of different structures, which are established either formally as branches or associates, or informally, for example, through an informal partnership arrangement. The requirements of this ISA apply equally to these informal structures as it does to more conventional group structures.
189. For example, ISA (UK) 600 would apply in both the following circumstances:
- A centrally administered organisation with branches in the UK and/or overseas where financial information prepared by each branch is aggregated into a single set of financial statements, but where statutory group financial statements are not required to be prepared.
  - A parent charity with a group structure including subsidiaries, joint ventures and associates.

#### *Branches*

190. A charity may operate through branches to raise funds or carry out particular aspects of its charitable activities. The principles as to whether branches in the charity's wider structure are accounted for as part of the charity are set out in the Charities SORP and these apply whether operations are carried out in the UK or overseas. In England and Wales separate charities may in certain circumstances account as one entity where a uniting direction has been issued by CCEW. Such entities will normally be listed as subsidiary registrations by CCEW.
191. Some charities will use the term "branches" outside of the Charities SORP meaning to describe a network of charities which are administratively autonomous and as such are separate accounting entities. The constitutional provisions in such cases may require careful consideration. Audits of independent (or autonomous) branches are regarded as separate engagements where a separate opinion is required.
192. The terms on which branches raise funds will also be relevant to determining the accounting policies of a charity. Local appeals may be for specific purposes, and where this is the case such funds will be restricted in the accounts of the main charity. The Charities SORP requires non-autonomous branches to be accounted for in the entity's financial statements and for consolidated financial statements to be prepared in group situations.
193. Irrespective of the accounting treatment of branches, the auditor's application of ISA (UK) 600 is driven by whether the branch prepares financial information that is included in the charity's financial statements.

#### *Overseas operations*

194. Where charitable groups have overseas components, the group engagement team considers whether the financial information of the components (whose statutory accounts may not be prepared in accordance with the Charities SORP) are appropriately consolidated into the group financial statements (which are prepared in accordance with the Charities SORP).
195. The group engagement team considers whether the instructions issued by the charity to components adequately describe the applicable requirements of the Charities SORP to that component.

196. The group engagement team may also request the component auditor to perform specified audit procedures that respond to an identified risk of material misstatement (e.g., asking the component auditor to specifically consider if the component has received any restricted funds). Depending on the local financial reporting framework, this may require details of the accounting requirements under the Charities SORP to be explained to the component auditor.

**Access to information** (Ref: Para. 13)

197. Where the charity is a company, there is a statutory obligation on any subsidiary undertaking which is a company incorporated in Great Britain, and on its auditor, to give to the auditor of the parent company such information and explanations as it may reasonably require for the purposes of its duties.
198. The auditor in England and Wales acting under the 2011 Act (E&W) has, under Section 154(1)(d) of the Act, a right of access to books, documents and records which relate to the charity. This access right extends beyond those records which are in the ownership of the charity and, under the 2008 Regulations (E&W), includes the records of any UK subsidiaries of the charity. However, this right will not extend to overseas entities with a separate legal constitution. In Northern Ireland, the auditor will have the same right of access under Section 66(1)(d) of the 2008 Act (NI), when commenced. In Scotland this right applies to all legal forms of charity registered in Scotland and is given under Regulation 13 of the 2006 Regulations (Scotland).

## **ISA (UK) 700: FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS**

ISA (UK) 700 (Revised June 2016) deals with the auditor's responsibility to form an opinion on the financial statements, and the form and content of the auditor's report issued as a result of an audit of financial statements.

### **Forming an opinion on the financial statements** (Ref: Para. 10–15)

199. The auditor's opinion on a charity's financial statements is expressed in the context of the particular legislation and accounting requirements applicable to the charity concerned.
200. The auditor is also aware that the trust deed establishing a charity may establish additional requirements concerning the contents of its financial statements (but cannot derogate from the statutory requirements). The auditor therefore assesses whether any such requirements are met. Where the auditor becomes aware of information which indicates that a transaction or transactions undertaken by the charity may have breached any terms of its trust deed, the auditor considers the implications for the auditor's reporting responsibilities following the requirements of ISA (UK) 250 (Revised June 2016) and the guidance in Section *ISA (UK) 250* of this Practice Note.
201. As far as charitable companies<sup>70</sup> in England, Wales and Scotland<sup>71</sup> are concerned, care needs to be taken to understand the interaction between Companies Act 2006, the relevant Charities Acts. For charitable companies claiming audit exemption under the Companies Act 2006, the legal requirements for audit are provided in the relevant Charities Acts. A small charitable company that is eligible for audit exemption under Companies Act 2006 but does not claim this exemption continues to be audited under Companies Act 2006 and in England and Wales no additional audit requirement arises under the 2011 Act (E&W).
202. For charitable companies that do claim audit exemption and comply with Section 475(2) to (4) of the Companies Act 2006, which requires a statement on the face of the balance sheet confirming that the company is entitled to audit exemption, the audit arrangements referred to in the auditor's reports are the 2011 Act (E&W) and the 2005 Act (Scotland).
203. For charitable companies below the Companies Act 2006 audit threshold and claiming exemption but above the thresholds of the relevant Charities Acts this could be achieved by a statement such as:

*For the year ended [date] the company was entitled to exemption from audit under Section 477 of the Companies Act 2006 relating to small companies but as this company is a charity, it is subject to audit under the [Charities Act 2011 / Charities and Trustee Investment (Scotland) Act 2005 / Charities Act (Northern Ireland) 2008].*

*a. The members have not required the company to obtain an audit of its accounts for the year in question in accordance with Section 476 of the Companies Act 2006.*

*b. The directors acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 with respect to accounting records and the preparation of accounts.*

*These accounts have been prepared in accordance with the provisions applicable to companies subject to the small companies' regime.*

<sup>70</sup> This guidance does not apply to groups.

<sup>71</sup> In Northern Ireland the special rules for the audit of small charitable companies provided by the Companies Act is currently retained.



204. The form and content of auditor's reports on the financial statements of charities follow the requirements established by ISA (UK) 700 (Revised June 2016). However, because of the complexity of the legal framework, the auditor needs to ensure descriptions of the legislative basis and responsibilities of the auditor and trustees are specific to the circumstances of the charity audited.

### **Auditor's report**

*Addressee* (Ref: Para. 22)

205. Audit reports made under company legislation are addressed to members (in Scotland – members and trustees) whilst reports made under charity law are made to the trustees.

*Key audit matters* (Ref: Para. 31)

206. The auditor of a charity is not required by this ISA (UK), or otherwise by laws or regulation, to communicate key audit matters in the auditor's report in accordance with ISA (UK) 701. However, the trustees may be keen to demonstrate their commitment to transparent reporting and therefore may request the auditor to communicate key audit matters in the auditor's report, in which case this is done in accordance with ISA (UK) 701.<sup>72</sup>

*Responsibilities for the financial statements* (Ref: Para. 33–36)

207. ISA (UK) 700 (Revised June 2016) requires the auditor to include a section describing the trustees' responsibility for:

- The preparation of the financial statements in accordance with the applicable financial reporting framework, and for such internal control as the trustees determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- Assessing the charity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate.

208. The responsibilities of the trustees will also vary according to the constitution of the particular charity, for example, the duties of trustees of charitable companies derive from both company and charity law.

209. The auditor needs to be aware that where charities are required to prepare accounts under more than one UK jurisdiction, both sets of legal requirements must be adhered to.

*Other reporting responsibilities* (Ref: Para. 43–45)

210. The auditor of a charity is required to include a statement in the auditor's report on the financial statements if it concludes that:

- The charity has not kept accounting records in accordance with the relevant Act; or
- The financial statements are not in agreement with the accounting records; or
- The trustees' report is inconsistent with the financial statements;<sup>73</sup> or
- Necessary information and explanations have not been made available to the auditor.

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<sup>72</sup> ISA (UK) 701, paragraph 31.

<sup>73</sup> For further guidance see Section *ISA (UK) 720* of this Practice Note.

*Signature of the auditor* (Ref: Para. 47)

211. For charitable companies who are required, or opt, to be audited under the Companies Act 2006, the auditor's report must be signed by the Senior Statutory Auditor in his or her own name for and on behalf of the firm.
212. For charitable companies audited under the relevant Charities Acts, or for non-corporate charities, the auditor's report is signed in the name of the firm only.
213. The relevant Charities Acts require that the auditor state in the auditor's report that the firm is eligible to act as an auditor in terms of Section 1212 of the Companies Act 2006, even where the charity is not audited under the Companies Act 2006.

## **ISA (UK) 720: THE AUDITOR'S RESPONSIBILITIES RELATING TO OTHER INFORMATION**

ISA (UK) 720 (Revised June 2016) sets out the auditor's responsibilities relating to other information included in the annual report.

### **Other information** (Ref: Para. 12(c))

214. A charity's annual report may include the following other information, alongside the financial statements and auditor's report:

- A trustees' annual report (including, for charitable companies, the directors' report and strategic report as required).
- Statements by the patron, president, chairman of the trustees and/or chief executive of the charity.
- An operating and financial review.
- An investment policy and performance report.
- A statement of grant making policies.
- A statement of reserves policy.
- A statement of achievements against objectives.
- An impact assessment.
- A risk management statement by trustees (based on the Charities SORP or expanded and based on the UK Corporate Governance Code for listed companies).
- A treasurer's report.
- Financial summaries.
- Projections of future expenditure based on planned activity.

215. Charity trustees may request the auditor specifically to review and report on a corporate governance or risk management statement made by them in their annual report or contained in other information presented with the financial statements. Providing guidance on a review of this nature is beyond the scope of this Practice Note.

### **Statutory other information** (Ref: Para. 12(d))

216. The trustees' report meets the definition of statutory other information as the auditor is required to report publicly on these reports in the auditor's report in accordance with law or regulation. For both charities and charitable companies, the auditor is required to report<sup>74</sup> on whether the information given in the trustees' report is inconsistent with the financial statements.

### **Obtaining an understanding of the charity and its environment relating to statutory other information** (Ref: Para. 12-1)

217. The auditor obtains an understanding of the requirements of the applicable legal and regulatory requirements for the trustees' report and how the charity is complying with those requirements.

218. Requirements applicable to the trustees' report include:

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<sup>74</sup> For charities, the auditor reports by exception; whereas for charitable companies, the auditor is required to give an opinion on such matters.

- Applicable legislative requirements.<sup>75</sup>
- Module 1 *Trustees' annual report* of the Charities SORP.

**Reading and considering the other information** (Ref: Para. 14–15)

219. The auditor reads all of the other information included in the charity's annual report and considers whether there is a material inconsistency between the other information and both the financial statements or the auditor's knowledge obtained in the audit.
220. The ISA (UK) does not require the auditor to perform additional procedures to verify other information that either does not relate to amounts or other items in the financial statements or about which the auditor has no knowledge. For example, the trustees may include a statement in the other information that there has been a 27% increase in visitors to a charity's website during the year. If the financial statements contained no similar disclosures and if the auditor, as part of the audit, had not obtained knowledge in respect of visitors to the charity's website, the auditor would not be required to undertake further procedures to verify that this statement was materially misstated. However, if the auditor, as part of the audit, reads information in the minutes of the trustees' meetings that contradicts this statement, then the auditor would need to undertake further procedures to determine whether that statement was materially misstated.
221. Similarly, whilst the auditor is not expected to verify any risk management statement made by trustees, the auditor is likely to become aware of the steps taken by the trustees to identify and manage identified financial risks through its work in assessing audit risk under ISA (UK) 315. The auditor may also become aware of non-financial risks during the course of the audit.
222. In addition, because the trustees' report is statutory other information, the auditor also considers whether the trustees' report appears to be materially misstated in the context of the auditor's understanding of the applicable law and the Charities SORP requirements.<sup>76</sup>
223. ISA (UK) 720<sup>77</sup> explains that a misstatement of the other information exists when the other information is incorrectly stated, otherwise misleading or omitted, or when the trustees' report has not been prepared in accordance with applicable law and Charities SORP requirements. For example, a misstatement of the other information arises where the trustees' report does not include commentary on the significant events that have affected the financial performance and financial position of the charity during the year, or, in the auditor's professional judgment, the commentary omits a significant event.
224. Where the auditor has identified an apparent misstatement of the other information, the auditor discusses the matter with the trustees. The ISA (UK) acknowledges that it may be more difficult for the auditor to challenge the trustees on matters of judgment than on those of a more factual nature<sup>78</sup>; however, the auditor has a unique insight into the charity and there may be circumstances where the auditor concludes that the trustees' report contains information that is not consistent with financial statements or the auditor's knowledge obtained in the audit.
225. In concluding on whether there is a material misstatement of the other information, the auditor applies professional judgment, taking into account such matters, where relevant, as:

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<sup>75</sup> See Appendix 2 of this Practice Note.

<sup>76</sup> See paragraphs 217–218 of this Practice Note.

<sup>77</sup> ISA (UK) 720 (Revised June 2016), paragraph 12(b).

<sup>78</sup> ISA (UK) 720 (Revised June 2016), paragraph A41.

- Whether the misstatement of the other information is material by size or by nature.<sup>79</sup>
- The information needs of the primary users of the annual report.
- Whether the requirement in the Charities SORP is a mandatory requirement (a “must”) or indicative of best practice (“should”).<sup>80</sup>
- Any views expressed by the charity regulators (or other appropriate authority outside the charity).

**Reporting** (Ref: Para. 21–23)

226. The auditor of a charity reports in the auditor’s report as follows:

- On the trustees’ report (and any other statutory other information):
  - For charitable companies, in accordance with ISA (UK) 720 (Revised) paragraph 22D-1; and
  - For all other charities, in accordance with the relevant law or regulation.
- On all other information, in accordance with paragraph 22 of ISA (UK) 720 (Revised June 2016).

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<sup>79</sup> ISA (UK) 720 (Revised June 2016), paragraph A7 discusses the concept of materiality as it applies to the other information.

<sup>80</sup> The terms “must”, “should” and “may” are explained in paragraphs 32-35 of the Charities SORP.

## REPORTING MATTERS OF MATERIAL SIGNIFICANCE TO CHARITY REGULATORS

### Reporting to charity regulators

227. In addition to the primary objective of reporting on financial statements, the auditor of a charity may have an additional statutory duty to report in certain circumstances to the relevant charity regulator. This duty is wider than the requirement in ISA (UK) 250 Section A (Revised June 2016) to report identified or suspected non-compliance with laws and regulations to an appropriate authority outside the charity.<sup>81</sup>
228. In the case of registered charities this duty will be to the charity regulators (CCEW, OSCR or CCNI as appropriate), while for exempt charities this will be their principal regulator (e.g., the Higher Education Funding Council for England in the case of English universities).
229. In order to assist the auditor to comply with the auditor's statutory duty to report such matters, the charity regulators have jointly issued guidance for auditors (Matters of Material Significance Guidance).<sup>82</sup> The auditor of a charity is expected to have an understanding of this guidance in order to ensure that the auditor complies with the auditor's additional responsibilities arising from legislation.
230. ISA (UK) 250 Section B (Revised June 2016)<sup>83</sup> does not apply generally to charities, unless the charity also meets the definition of "regulated entity" included in that ISA (UK).
231. The legislative basis for the charity auditor's statutory duty to report is:
- England and Wales: Sections 156 to 159 of the 2011 Act (E&W) require the auditor to communicate to CCEW certain matters of which it becomes aware in their capacity as the auditor of a charity. The statutory duty to report to CCEW extends to charities excepted from registration but does not extend to exempt charities.<sup>84</sup>
  - Scotland: Section 46 of the Charities and Trustee Investment (Scotland) Act 2005, which sets out the duty of the auditor of all forms of charity registered in Scotland to report to OSCR. OSCR has similar investigative powers to those of CCEW.
  - Northern Ireland: Sections 67 of the 2008 Act (NI) requires the auditor to communicate to CCNI certain matters of which the auditor becomes aware in its capacity as the auditor of a charity or a charitable company.

These provisions also establish the right to report a matter to the charity regulator which does not appear to fall within the scope of the duty to report but which the auditor has reasonable cause to believe is likely to be relevant to the charity regulator for the purposes of the exercise of any of its functions. The right to report, like the duty to report, applies to charitable companies and to non-company charities.

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<sup>81</sup> ISA (UK) 250 (Revised June 2016), *Section A—Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 29.

<sup>82</sup> See *Matters of Material Significance reportable to UK charity regulators*, available to download from: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/611139/Matters\\_of\\_Material\\_Significance\\_reportable\\_to\\_UK\\_charity\\_regulators.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/611139/Matters_of_Material_Significance_reportable_to_UK_charity_regulators.pdf)

<sup>83</sup> ISA (UK) 250 (Revised June 2016), *Section B—The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector*, paragraph 9(e).

<sup>84</sup> 'Exempt' charities are excluded from the CCEW's supervision and monitoring, and consequently its auditors are not required to report material of material significance to CCEW. Instead, the auditor of an exempt charity reports such matters to the charity's principal regulator. There is, however, no disapplication of the reporting duty for exempt company charities.

232. The 2011 Act (E&W), the 2005 Act (Scotland) and the 2008 Act (NI) specify the matters which give rise to a duty to make an immediate report to the relevant regulator as those which:
- (a) Relate to the activities or affairs of the charity or of any connected institution or body, and
  - (b) The auditor has reasonable cause to believe is, or is likely to be, of material significance for the exercise, in relation to the charity, of the relevant regulator's functions.<sup>85</sup>
233. Where a charity is registered in multiple jurisdictions, if there is any doubt as to which regulator the auditor should make a report to, the auditor makes a report to all relevant regulators.
234. The Charities Acts do not require the auditor to perform any additional audit work as a result of the statutory duty, nor is the auditor required specifically to seek out breaches of the requirements applicable to a particular charity. However, in circumstances where the auditor identifies that a reportable matter may exist, the auditor carries out such extra work, as considered necessary, to determine whether the facts and circumstances give it 'reasonable cause to believe' that the matter does in fact exist. The auditor's work does not need to prove that the reportable matter exists.
235. Where possible, it is the charity regulators' practice to seek to resolve issues collaboratively with a charity. However, if the charity declines to co-operate or assist, the charity regulator has the power to institute inquiries with regard to charities or a particular charity or class of charities, either generally or for particular purposes. The charity regulator also has powers to obtain information, including the power to call for documents and require persons to give evidence. The charity's auditor may also be required to provide information.<sup>86</sup>

### **Criteria for determining the existence of a duty to report to the charity regulators**

236. Determining whether a matter is reportable to a charity regulator involves consideration both of whether the auditor has a 'reasonable cause to believe' and that the matter in question 'is, or is likely to be of material significance' to the charity regulators.
237. 'Material significance' is not defined in legislation; however, the Matters of Material Significance Guidance explains that it relates to matters which are of material significance to a regulator in carrying out their functions.
238. Matters which the UK charity regulators have jointly agreed are of material significance are set out in the Matters of Material Significance Guidance. Other sources of useful information relevant to the particular jurisdiction are also available from the charity regulators' individual websites
239. 'Material significance' does not have the same meaning as materiality in the context of the audit of financial statements. Whilst a particular event may be trivial in terms of its possible effect on the financial statements of a charity, it may be of a nature or type that is likely to change the perception of the charity regulator. For example, dishonesty by a trustee may not be significant in financial terms in comparison with the income of the charity but would have a significant effect on the relevant charity regulator's

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<sup>85</sup> For CCEW this is Sections 46, 47 and 50 (inquiries) and 76 and 79 to 82 (power to act for protection of charities) of the 2011 Act (E&W), for OSCR this is Sections 28 (inquiries about charities), 30 (removal from the Register of a charity which no longer meets the test) and 31 (powers of OSCR following enquiries) of the 2005 Act (Scotland) and for CCNI it will be Section 22 (general power to institute inquiries) or 33 (power to act for the protection of charities) of the 2008 Act (NI) once commenced.

<sup>86</sup> For CCEW this is Section 46 of the 2011 Act (E&W), for OSCR this is Sections 28 and 29 of the 2005 Act (Scotland) and, for CCNI this is Section 22 of the 2008 Act (NI).

consideration of whether the person concerned should be allowed to continue to act as a charity trustee.

240. The determination of whether a matter is, or is likely to be, of material significance to the charity regulators inevitably requires the auditor to exercise professional judgment. In forming such judgments, the auditor needs to consider not simply the facts of the matter but also their implications. In addition, it is possible that a matter, which is not materially significant in isolation, may become so when other possible breaches are considered, together with other reported and unreported breaches of which the auditor is aware.
241. The auditor of a charity bases a judgment of 'material significance' to the charity regulator solely on the auditor's understanding of the facts of which it is aware without making any assumptions about the information available to the charity regulator in connection with any particular charity.
242. Minor breaches of trustees' obligations, or isolated administrative errors that are unlikely to jeopardise the charity's assets or amount to misconduct or mismanagement would not normally be of 'material significance'. However, based on the auditor's knowledge obtained in the audit, the auditor assesses whether the cumulative effect is of 'material significance' such as to give rise to a duty to report to the charity regulator. In circumstances where the auditor is uncertain whether the auditor may be required to make a report or not, the auditor considers taking legal advice.
243. Where a situation is identified and the auditor, having considered the Matters of Material Significance Guidance and the guidance provided in this Section of the Practice Note, remains uncertain as to whether the matter is likely to be of 'material significance' the auditor may wish to discuss the circumstances giving rise to its concern with the charity regulators.<sup>87</sup> Whilst such discussions may help inform the auditor in reaching a conclusion as to whether a particular matter is likely to fall within the charity regulator's regulatory function, it is not used as a substitute for the auditor's own professional judgment. Such discussions do not remove the need to report where the matter is considered to be reportable.
244. On completion of any investigations, the auditor ensures that the facts and circumstances, and the basis for the conclusion that these are, or are likely to be of 'material significance' to the charity regulator, are adequately documented such that the reasons for the auditor's decision to report may be clearly demonstrated if the need to do so arises in future.
245. Whilst confidentiality is an implied term of the auditor's contract with a charity, in the circumstances described in the relevant Charities Acts,<sup>88</sup> it does not prevail. Subject to compliance with legislation regarding tipping off, in the circumstances leading to a right or duty to report the auditor is required to communicate information or opinions on a matter relating to the affairs of the charity or any connected institution or body. The defence afforded to the auditor from any potential breach of duty is given in respect of information obtained in the capacity as auditor.
246. In addition, an auditor who ceases to hold office, for any reason, is required by the relevant Charities Acts or Regulations<sup>89</sup> to make a statement as to whether there are any matters concerning the auditor ceasing to hold office which should be brought to the

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<sup>87</sup> The Matters of Material Significance Guidance states: The UK charity regulators' default preferences for auditors is "When in doubt, report it".

<sup>88</sup> Sections 156 to 159 of the 2011 Act (E&W); Section 46 of the 2005 Act (Scotland); and Section 67 of the 2008 Act (NI).

<sup>89</sup> Paragraph 35 of the 2008 Regulations (E&W); Regulation 10(6) of the 2006 Regulations (Scotland) (as amended); and similar powers are included in the 2008 Act (NI).



attention of the trustees and to send a copy of the auditor's statement to the charity regulator.

### **Conduct of the audit**

247. It is not part of the reporting duty to require an auditor to perform any additional work as a result of the statutory duty, nor is the auditor required specifically to seek out reportable matters. However, the auditor includes procedures within the planning process to ensure that members of the engagement team have sufficient understanding (in the context of the individual's role) to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator.
248. Where a matter comes to light relating to a previous financial year which would give rise to a duty to report, then the auditor still makes a report.

### **Connected entities**

249. The auditor needs to be aware that the duty to report extends to any institution or body corporate connected with the charity.<sup>90</sup> The auditor decides whether there are any matters to be reported to the charity regulators relating to the affairs of the charity in the light of the information that the auditor receives about a connected entity for the purpose of auditing the financial statements of the charity. If the auditor is aware of possible circumstances that may fall due to be reported, the auditor has a right and duty to do this under the relevant Charities Acts.<sup>91</sup> At the planning stage of the audit, the auditor of the charity considers whether arrangements need to be put in place to allow the auditor to communicate with the management to obtain further information direct from the management or auditor of the connected entity and to enable the auditor to determine whether the matter should be reported. An inability to communicate with the connected entity or its auditor does not preclude the duty to report. In such circumstances the auditor reports the circumstances and the fact that the auditor has been unable to obtain further information, direct to the charity regulator.

### **Discussing matters of material significance with trustees**

250. The trustees are the persons principally responsible for the governance of the charity. In forming a conclusion, the auditor will therefore normally seek to reach agreement with the trustees on the circumstances giving rise to a report and to understand whether the trustees intend to make a report.
251. The trustees should consider reporting the matters identified to the charity regulator themselves and detail the actions taken or to be taken. Whilst such a report from the trustees may provide valuable information, it does not relieve the auditor of the statutory duty to report directly to the charity regulator.
252. If the auditor suspects that the trustees are involved in non-compliance, or when the matter giving rise to a statutory duty to make a report direct to a regulator casts doubt on the trustees' integrity or their competence to conduct the charity, the auditor makes the report to the charity regulator without informing the trustees. Additionally, in the case of money laundering suspicions, to ensure that 'tipping off' does not occur the auditor cannot undertake to inform trustees in advance of every matter which it brings to the regulator's attention.<sup>92</sup>

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<sup>90</sup> 'Connected' includes any institution controlled by the charity or a body corporate in which the charity has a substantial interest (20% or more of the share capital or voting rights) (Sections 157, 351 and 352 of the 2011 Act (E&W) and Section 46(5) of the 2005 Act (Scotland)).

<sup>91</sup> Section 156(2) and 156(4) of the 2011 Act (E&W); Section 46 of the 2005 Act (Scotland); and Section 67(3) of the 2008 Act (NI).

<sup>92</sup> See also paragraphs 58–59 of this Practice Note.

## **Contents of a report to the charity regulators**

253. The reporting of a matter of material significance is a separate report from the auditor's report on the financial statements.
254. The Matters of Material Significance Guidance sets out the required information.
- In England and Wales and Northern Ireland, the report to CCEW or CCNI is required to be in writing. This can include making a report by email. The auditor is not relieved of the duty to make a written report where an oral report has been previously made to a charity regulator or by any informal discussions of the issue with a charity regulator's staff. Similarly, the auditor is not relieved of the duty to report on the basis that any other party has provided relevant information, whether written or oral, to a charity regulator.
  - In Scotland, there is no legislative requirement to make the report in writing but OCSR recommends that a written report or record of any verbal report is forwarded to OSCR.
255. Where trustees wish to make a submission to the charity regulator as to the circumstances and steps being taken to address a reportable matter, the auditor may attach such a memorandum or report prepared by the trustees to the auditor's report to the charity regulator.
256. Where such additional information is provided the auditor refers to the additional information in the report, and indicates whether or not the auditor has undertaken additional procedures to determine whether any remedial actions described have been taken.

## **Timing of a report**

257. The relevant Charities Acts require the report to be made immediately the matter comes to the auditor's attention.
258. The duty to report arises once the auditor has concluded that there is reasonable cause to believe that the matter is or is likely to be of material significance to the relevant charity regulator's regulatory function. In reaching a conclusion the auditor may wish to consult with others within the firm, a network firm, a professional body, or with the auditor's legal counsel.
259. The report is made without undue delay once a conclusion has been reached. Unless the matter casts doubt on the integrity of the trustees, this will not preclude discussion of the matter with trustees and seeking such further advice as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are however undertaken on a timely basis to enable the auditor to conclude on the matter without undue delay.

## **Information received in a capacity other than as auditor**

260. There may be circumstances where it is not clear whether information about a charity coming to the attention of the auditor is received in the capacity of auditor or in some other capacity, for example, as general adviser to the charity. Appendix 2 to ISA (UK) 250 Section B<sup>93</sup> provides guidance as to how information obtained may be relevant to the auditor in the planning and conduct of the audit and the steps that need to be taken to ensure the communication of information that is relevant to the audit. The auditor considers matters that are potentially of material significance to the charity regulator, and which arise in this context and if appropriate report these.

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<sup>93</sup> Whilst ISA (UK) 250 (Revised June 2016) Section B does not apply to the audits of charities, the procedures and guidance in that ISA (UK) can be adapted to similar circumstances for the auditor of a charity.

### **Failure to fulfil the statutory duty to report**

261. Failure to comply with the relevant Charities Acts<sup>94</sup> is regarded as a matter for the professional bodies to deal with pursuant to their own disciplinary procedures. For cases where the charity regulators have decided to make a complaint they have indicated that, within any legal restrictions that may apply, they will make available to those professional bodies any relevant information in their possession.

### **Auditor's right to report to a charity regulator**

262. The auditor also has a separate right to report where there is no statutory duty.<sup>95</sup> The auditor may determine that other matters that are not specified as reportable in the Matters of Material Significance Guidance<sup>96</sup> are, in the auditor's professional judgment, of such a nature that the auditor considers them reportable as a matter of material significance.<sup>97</sup>

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<sup>94</sup> Sections 156 to 159 of the 2011 Act (E&W); Section 46 of the 2005 Act (Scotland); or Sections 67 and 103 of the 2008 Act (NI).

<sup>95</sup> Section 156(4) for non-company charities and Section 159(1) for charitable companies of the 2011 Act (E&W); Section 46 of the 2005 Act (Scotland); and Section 67 of the 2008 Act (NI).

<sup>96</sup> See Sections 2 and 3 of the Matters of Material Significance Guidance for a list of the reportable matters of material significance.

<sup>97</sup> For examples of such matters, see paragraphs 67 and 183 of this Practice Note.

### **Conditions and events that may indicate risks of material misstatement**

The following are examples of conditions and events that may indicate the existence of risks of material misstatement in the financial statements. The examples provided may be of particular relevance to charities and are in addition to the broad range of conditions and events included in the ISAs (UK);<sup>98</sup> however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

#### **General**

- Extent and nature of non primary purpose trading activities.
- Evidence of failure to act in accordance with those objects and powers in the charity's governing documents.
- Difficulties of the charity in establishing ownership and timing of voluntary income where funds are raised by non-controlled bodies.
- Overseas operations. In particular:
  - Significant aspects of a charity's business may be conducted in conditions or locations which impede access to the accounting records.
  - Transactions may be in a number of different and volatile currencies.
  - Due to the location of the activities management may have reduced oversight and limited ability to monitor activities and transactions.
  - Governance, responsibility and accountability may be unclear regarding branches, joint ventures and the use of partners in overseas locations.
  - Non-compliance with local laws and regulation.
  - Conduit funding,<sup>99</sup> or informal banking arrangements.
  - The risk of a tax liability arising if HMRC consider that reasonable steps have not been taken to ensure overseas payments are being allocated to charitable purposes only.

#### **Classes of transactions, account balances and disclosures**

- Allocation of costs between different expenditure categories in the Statement of Financial Activities (SoFA).
- Restricted funds which require special considerations as to use and accounting, including clawback of restricted grants or contracts.
- Grants payable or receivable.
- Contracts with performance related conditions.
- Donations in kind (i.e., donated goods, facilities and services including goods for resale, use by the charity or distribution to a third party).
- Legacies.

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<sup>98</sup> See: ISA (UK) 315 (Revised June 2016), Appendix 2; ISA (UK) 570 (Revised June 2016), paragraph A3; and ISA (UK) 600 (Revised June 2016), Appendix 3.

<sup>99</sup> Resources received and distributed by a charity as agent for another entity, usually another charity. The principal in the arrangement is the charity providing the resources who retains the legal responsibility for the charitable application of the funds.

- Heritage assets.
- Events or transactions that involve significant measurement and recognition uncertainty, including accounting estimates, and related disclosures. In particular:
  - Defined benefit pension schemes, including the complexity of allocating pension deficits/assets between funds and the effect of these deficits/assets on their free reserves.
  - Multi-employer defined benefit pension scheme liabilities, including the recognition of an agreed deficit recovery plan.
  - Investments (including social investments) whether financial or programme-related investments (bid price should be used).
  - Properties which are partly used for the charity's operations and partly for investment purposes.
  - Loans where there is a material arrangement calculated using the 'effective interest method' (i.e., by applying a constant 'interest' rate to the outstanding amount).
  - Fair value of assets and liabilities acquired where acquisition accounting is applied (in this situation, the due diligence process may only provide limited information on the fair value of some assets such as land and buildings and heritage assets).
  - Recognition of second hand goods received for resale or goods for distribution and stock (if applicable).
  - Recognition of other donations in kind at a reasonable estimate of their gross value to the charity and donated services and facilities at a reasonable estimate of the value to the charity of the service or facility received.
  - Other arrangements which are offered or received on extended terms of more than twelve months will be discounted to their present value (using the market interest rate for an equivalent debt instrument, usually investment return to the charity). This can include:
    - Donations and grants.
    - Long term grant commitments.
    - Accrual for legacies receivable.
 at their present value in the balance sheet.
- Taxation matters including income from gift aid and the gift aid small donations scheme, the identification of tainted donations and the recognition of irrecoverable VAT.
- Commitments and liabilities, including constructive obligations.
- Restricted and unrestricted reserves.
- Departures from the Charities SORP.

### **CHARITY ACCOUNTING AND AUDIT REQUIREMENTS IN THE UNITED KINGDOM**

The information in this Appendix gives an overview of the regulatory framework for charities and the legal framework for charity accounts and audit. Requirements change over time and reference should be made to information on the websites of the UK charity regulators and directly to the relevant legislation and regulations as considered necessary.

#### **Overview**

1. There are three charity law jurisdictions in the UK and three charity regulators:
  - In England and Wales, the Charities Act 2011 (2011 Act (E&W)) provides the primary legislative framework for charity regulation by the Charity Commission for England and Wales (the CCEW) supplemented by some provisions of the Charities (Protection and Social Investment) Act 2016.
  - In Scotland, the Charities and Trustee Investment (Scotland) Act 2005 (2005 Act (Scotland)) provides the primary legislative framework for charity regulation by the Office of the Scottish Charity Regulator (OSCR).
  - In Northern Ireland, the Charities (Northern Ireland) Act 2008 (2008 Act (NI)) provides the primary legislative framework for charity regulation by the Charity Commission for Northern Ireland (the CCNI).
2. Charitable status is available to organisations with different legal forms which means that they may fall with the scope of regulatory regimes governed by other legislation. It is common for charities to also be companies limited by guarantee and all charitable companies must comply with the Companies Act 2006 including the accounting and auditing requirements therein. Within England and Wales those charities that are classified as exempt fall to be regulated by an alternative principal regulator and are not regulated by the CCEW.
3. Charities may be required to comply with aspects of charity law in more than one UK charity law jurisdiction. Such charities are known as 'cross border' charities:
  - A charity which is established in England and Wales or in Northern Ireland with activities in Scotland may need to register with the OSCR. Where the extent of the charity's activities requires registration, the charity must comply with the 2005 Act (Scotland) including the related accounting and external scrutiny requirements. Compliance with the 2005 Act is in addition to any requirements placed on the charity by the charity law of its home jurisdiction, including the accounting and external scrutiny requirements, and any other legislation which applies to its legal form, for example, company law.
  - A charity which is established in England and Wales or in Scotland with activities in Northern Ireland may in future be required to register with the CCNI if it is not a charity under the law of Northern Ireland but operates for charitable purposes in or from Northern Ireland. Such a charity is known as 'a Section 167 charity'. Also, in future, a Section 167 charity will be required to file, with the CCNI, a financial statement; and a statement of activities, relating to its operations in or from Northern Ireland. At the date of publication of this Practice Note, the provisions of Section 167 of the 2008 Act (NI) have not been implemented.

## THE REGULATORY FRAMEWORK

### England and Wales

4. The CCEW is responsible for the registration, supervision and regulation of charities that are not exempt. A public register of charities is maintained. All charities must register with the CCEW unless:
  - The charity's gross income in the financial year is £5,000 or less; or
  - The charity is excepted from registration and gross income in the financial is £100,000 or less; or
  - The charity is exempt from registration by order or regulation.
5. Under the 2011 Act (E&W), the CCEW may by order require any person to furnish them with any information in their possession which relates to any charity and is relevant to the discharge of their functions. These powers extend to all charities whatever their legal form. Certain types of charity may also be monitored by other bodies, for example, by the Higher Education Funding Council for England in the case of universities in England or the Education Funding Agency for academy schools.

#### *Excepted charities*

6. Excepted charities are regulated by the CCEW. They are called excepted charities because they have been excepted from registration with the CCEW by order or regulation. Excepted charities with a gross income of more than £100,000 in a financial year can no longer retain excepted status and must now register with the CCEW. The £100,000 threshold is in place until 31 March 2021.
7. Excepted charities are required to prepare annual accounts and are subject to the same audit or examination requirements as registered charities. If registered, they must also prepare an annual report and annual return and file them and their accounts with the CCEW where required by regulation.

#### *Exempt charities*

8. Exempt charities in England and Wales are excluded from the CCEW's supervision and monitoring. Principal regulators are appointed for different classes of exempt charities. Exempt charities do not register with the CCEW, nor do they submit accounts and annual returns. However, they do have the same status and tax benefits as other charities and must comply with general charity law.
9. Where no suitable principal regulator can be identified for a class of exempt charities, that class of charities will lose its exempt status. Such a charity can become excepted provided its gross income is less than £100,000 in a financial year.
10. Many registered charitable societies within the meaning of the Friendly Societies Act 1974 or the Co-operative and Community Benefit Societies Act 2014 are also currently exempt charities in England and Wales pending the full implementation of changes to the exempt status of such charities. However, it is anticipated that this class of charities other than those which are registered providers of social housing (registered social landlords) will cease to be exempt at some point in the future.
11. The 2011 Act (E&W) requires the accounts of exempt charities to be prepared on a 'true and fair' basis. The accounting, reporting and audit requirements placed on exempt charities will also be dependent on how such charities are constituted and any specific statutes or regulations applying to them. For example, if constituted as companies then company law reporting duties apply.

## **Scotland**

12. In Scotland, the main primary legislation is the 2005 Act (Scotland). Supervision of charities registered in Scotland is carried out by OSCR. OSCR's statutory functions are to:
- Determine whether bodies are charities.
  - Keep a public register of charities.
  - Encourage, facilitate and monitor compliance with the 2005 Act (Scotland).
  - Identify and investigate apparent misconduct, following which it has the power to take remedial action.
  - Give information, or make proposals, to the Scottish Ministers on matters relating to OSCR's functions.

Under the 2005 Act (Scotland), there are no excepted or exempt charities.

## **Northern Ireland**

13. The CCNI was established under the 2008 Act (NI) and this Act lays down the general functions of the Commission, which include:
- Determining whether institutions are or are not charities.
  - Establishing and maintaining an accurate and up-to-date register of charities.
  - Encouraging and facilitating the better administration of charities.
  - Identifying and investigating apparent misconduct or mismanagement in the administration of charities and taking remedial or protective action.

Under the 2008 Act (NI), there are no excepted or exempt charities.

## **Friendly Societies and Registered Societies**

14. There are relatively few remaining friendly societies with charitable status (also known as benevolent societies) – the Financial Conduct Authority regulates those that remain. The primary legislation relating to charitable societies is the Friendly Societies Act 1974, although new registrations under this Act are not permitted. A number of charities, primarily providers of social housing, are registered under the Co-operative and Community Benefit Societies Act 2014, which applies in England and Wales and Scotland, or the Industrial and Provident Societies Act (Northern Ireland) 1969.
15. In Scotland, charities which are registered under the Friendly Societies Act or the Co-operative and Community Benefit Societies Act are still subject to the provisions of the 2005 Act (Scotland). Similar arrangements apply in Northern Ireland.



## ACCOUNTING AND REPORTING REQUIREMENTS

### Summary of accounting requirements

Charitable company	Friendly or registered society	Non-company charity, excluding a friendly or registered society		
UK-wide	UK-wide	England and Wales <sup>100</sup>	Scotland	Northern Ireland
Accruals basis; 'true and fair' view required		Gross income no more than £250,000, option to prepare receipts and payments accounts	Gross income less than £250,000, option to prepare receipts and payments accounts	Gross income no more than £250,000, option to prepare receipts and payments accounts
		Accruals basis, 'true and fair' view required where gross income is £250,001 (or £250,000) or more		

### The Charities SORP and UK legal requirements

16. The Charities SORP applies to all charities in the UK required to prepare 'true and fair' accounts for reporting periods commencing on or after 1 January 2016, unless a more specialist Statement of Recommended Practice applies. The Charities SORP<sup>101</sup> states that where a separate SORP exists for a particular class of charities, those charities should adhere to that SORP instead. In the charity sector specialist SORPs exist for: registered social housing providers (registered social landlords), higher and further education institutions; and common investment funds.
17. While the Charities SORP is generally compatible with the requirements of UK law, it is recognised that where necessary, its recommendations should be adapted to meet any statutory requirements applying to the form and content of a charity's annual report and accounts, for example, regulations made in a particular charity law jurisdiction, the Companies Act 2006 or the Co-operative and Community Benefits Societies Act 2014. The recommendations of the Charities SORP should also be adapted to meet any special requirements of the charity's own governing document.

### Non-company charities with no additional specialist requirements or exemptions

18. For non-company charities, for example, unincorporated associations, charitable trusts, charitable incorporated organisations (CIOs) and Scottish charitable incorporated organisations (SCIOs), charity law applies to the preparation of the trustees' annual report and accounts as follows:
  - In England and Wales, this is the 2011 Act (E&W) and related regulations, principally the Charities (Accounts and Reports) Regulations 2008 (as amended) and the Charitable Companies Audit and Group Accounts Provisions Order 2008 (as amended).

<sup>100</sup> In England and Wales, registered charities with a gross income of £25,000 or less, and excepted charities which are not registered, are not required to submit a trustees' annual report and accounts to the CCEW, unless requested to do so. All registered charities must prepare a trustees' annual report, even if they are not requested to submit it to the CCEW.

<sup>101</sup> Paragraph 15 of the Charities SORP, *Scope and application*.

- In Scotland, this is the 2005 Act (Scotland) and the Charities Accounts (Scotland) Regulations 2006 (as amended).
- In Northern Ireland, this is the 2008 Act (NI) and the Charities (Accounts and Reports) Regulations (Northern Ireland) 2015.

### **Charitable companies**

19. Charitable companies are generally incorporated as companies limited by guarantee and the requirements of the Companies Act 2006 requires directors of companies to prepare accounts which give a true and fair view and to follow the reporting requirements therein. The individual accounts of a charitable company must be prepared in accordance with Section 396 of the Act. Section 396 allows for the adaption of formats enabling Charities SORP compliant accounts to be prepared by charitable companies. Module 15 of the Charities SORP provides guidance for charitable companies on preparing an annual report and accounts which are compliant with both the Companies Act 2006 and the Charities SORP.
20. The requirement that company accounts give a 'true and fair' view means that charitable companies, however small, must prepare their accounts on an accruals basis.
21. Charitable companies registered in England and Wales are also subject to certain provisions of the 2011 Act (E&W) relating to reports and accounts. For example, a trustees' annual report must be prepared under the 2011 Act (E&W) and group accounts must be prepared where the aggregate income of the group exceeds £1 million. This is a specialist area and reference should be made directly to the 2011 Act (E&W) and relevant regulations to determine how these apply in specific circumstances.
22. Charitable companies registered in Scotland are subject in full to the requirements of the 2005 Act and the Charities Accounts (Scotland) Regulations 2006 (as amended) relating to the trustees' annual report and accounts. A similar situation exists for charitable companies in Northern Ireland where they must also comply with the requirements of the 2008 Act and the Charities (Accounts and Reports) Regulations (Northern Ireland) 2015.

### **Friendly Societies and Registered Societies**

23. The accounting requirements for registered societies in England and Wales and in Scotland are set out in the Co-operative and Community Benefit Societies Act 2014 which requires 'true and fair' accounts to be prepared. All registered societies are required to submit an annual return, including the accounts, which are public records. In Northern Ireland, the equivalent legislation is the Industrial and Provident Societies (Northern Ireland) Act 1969, which will be updated by the Credit Unions and Co-operative and Community Benefit Societies Act (Northern Ireland) 2016, once the Act has been implemented. Similar provisions apply to societies with charitable status registered under the Friendly Societies Act 1974.

## EXTERNAL SCRUTINY REQUIREMENTS: AUDIT AND INDEPENDENT EXAMINATION

### Summary of external scrutiny requirements

24. The constitution of the charity may impose more demanding requirements but cannot derogate from the statutory requirements below.

*Non-company charities – charity law requirements only*

<b>England and Wales</b>	<b>Scotland</b>	<b>Northern Ireland</b>
<p>Independent examination where gross income is between £25,000 and £1 million</p> <p>Where gross income is over £250,000 the examiner must be a member of a specified body</p>	<p>Independent examination where gross income is less than £500,000</p> <p>Where gross income is £250,000 or more (or where 'true and fair' accounts are prepared and gross income is lower than £250,000), the examiner must be a member of a specified body</p>	<p>Independent examination where gross income £500,000 or less, unless dispensation is given by the CCNI</p> <p>Where gross income is over £250,000 the examiner must be a member of a specified body</p>
<p>Audit required where:</p> <ul style="list-style-type: none"> <li>• gross income is over £1 million</li> </ul> <p>or</p> <ul style="list-style-type: none"> <li>• gross assets are over £3.26 million and gross income is over £250,000</li> </ul>	<p>Audit required where:</p> <ul style="list-style-type: none"> <li>• gross income is £500,000 or more</li> </ul> <p>or</p> <ul style="list-style-type: none"> <li>• gross assets are over £3.26 million (where 'true and fair' accounts are prepared)</li> </ul>	<p>Audit required where gross income is more than £500,000</p>
<p>An audit must be undertaken by a registered auditor unless CCEW gives a dispensation</p>	<p>An audit must be undertaken by a registered auditor or by the Auditor General for Scotland or by an auditor appointed by the Accounts Commission for Scotland</p>	<p>An audit must be undertaken by a registered auditor or the Comptroller and Auditor General for Northern Ireland unless the CCNI gives dispensation</p>

*Charitable companies*

<b>England and Wales</b>	<b>Scotland</b>	<b>Northern Ireland</b>
Independent examination where gross income is between £25,000 and £1 million Where gross income is over £250,000, the examiner must be a member of a specified body	Independent examination required where gross income is less than £500,000 The examiner must be a member of a specified body	Independent examination where gross income £500,000 or less Where gross income is over £250,000 the examiner must be a member of a specified body
Audit required where: <ul style="list-style-type: none"> <li>gross income is over £1 million</li> </ul> or <ul style="list-style-type: none"> <li>gross assets are over £3.26 million <u>and</u> gross income is over £250,000</li> </ul>	Audit required where: <ul style="list-style-type: none"> <li>gross income is £500,000 or more</li> </ul> or <ul style="list-style-type: none"> <li>gross assets are over £3.26 million</li> </ul>	Audit required where gross income is more than £500,000
An audit must be undertaken by a registered auditor unless the CCEW gives a dispensation	An audit must be undertaken by a registered auditor or by the Auditor General for Scotland or by an auditor appointed by the Accounts Commission for Scotland	An audit must be undertaken by a registered auditor or the Comptroller and Auditor General for Northern Ireland unless the CCNI gives dispensation

**England and Wales**

25. The 2011 Act (E&W) applies charity audit provisions to non-company charities and charitable companies that are not being audited under the Companies Act 2006. Any charity not receiving an audit requires an independent examination unless its gross income is below £25,000.
26. However, charitable companies will be subject to the audit requirements of the Companies Act 2006: if the charitable company exceeds the Companies Act 2006 audit exemption threshold; or it is below the Companies Act 2006 audit exemption thresholds but no election has been made for audit exemption under that legislation.

**Scotland**

27. The 2005 Act (Scotland) and the Charities Accounts (Scotland) Regulations 2006 (as amended) apply to the audit and independent examination of all charities entered on the Scottish Charity Register including those also registered in other jurisdictions. Any charity on the Scottish Charity Register which does not receive an audit must receive and independent examination.
28. For charitable companies, the audit requirements of the 2005 Act (Scotland) and the Charities Accounts (Scotland) Regulations 2006 (as amended) are in addition to the audit requirements of the Companies Act 2006. As a result, charitable companies on the Scottish Charity Register will be audited under both sets of legislation unless the charitable company elects for audit exemption under the Companies Act 2006. Where such an election is made, the audit is undertaken solely under the 2005 Act (Scotland) and the Charities Accounts (Scotland) Regulations 2006 (as amended).
29. Scottish charity law requires the auditor to consider the trustees' annual report and to state whether or not the report meets the requirements of the regulations and an opinion,

where the auditor has formed one, that there is a material inconsistency between the annual report and the rest of the statement of account. Although there is some legal uncertainty, the Scottish Government has given a provisional view that the annual report is outside the scope of the “true and fair” view, and have said that they will clarify the legislation on this point when a suitable legislative vehicle is available.

30. OSCR has confirmed that it will not take any action if a charity files an auditor’s report that does not make a specific reference to the inclusion of the trustees’ annual report within the scope of the ‘true and fair’ view.

### **Northern Ireland**

31. The 2008 Act (NI) and the Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 apply to the audit and independent examination of all charities entered on the Northern Ireland Charity Register. Any charity on the Northern Ireland Charity Register which does not receive an audit must receive an independent examination.
32. For charitable companies, the audit requirements of the 2008 Act (NI) the Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 are in addition to the audit requirements of the Companies Act 2006. As a result, charitable companies on the Northern Ireland Charity Register will be audited under both sets of legislation unless the charitable company elects for audit exemption under the Companies Act 2006. Where such an election is made, the audit is undertaken solely under the 2008 Act (NI) and the Charities (Accounts and Reports) Regulations (Northern Ireland) Regulations 2015.

### **Charitable companies**

33. Charitable companies which do not exceed the Companies Act 2006 audit threshold may elect to take advantage of the audit exemption conferred by Section 477 of the Companies Act 2006. However, charitable companies which are eligible for audit exemption under the Companies Act 2006 but are above the lower threshold for audit contained within charity law must receive an audit under charity law if they elect not to be audited under the Companies Act 2006.
34. Only companies which qualify as ‘small’ under the Companies Act can elect for audit exemption. The criteria in the Companies Act 2006 (Section 382) for qualification as ‘small’ is any company which is not otherwise excluded from the small companies’ regime (Section 384), and meets two out of the following three conditions:
  - Annual gross income not exceeding £10.2 million;
  - Balance sheet total (i.e., gross assets) not exceeding £5.1 million; and
  - Average number of employees not exceeding 50.
35. If a charitable company decides to elect for audit exemption under the Companies Act 2006 then a statement to this effect is required on the charity’s balance sheet.
36. If a small company claims audit exemption under the Companies Act 2006, the following applies:
  - In England and Wales, it will still need an audit or independent examination under the 2011 Act (E&W), if the relevant threshold in charity law is exceeded.
  - In Scotland, it will require either an audit or independent examination under the 2005 Act (Scotland), as determined by the relevant threshold in Scottish charity law. This includes ‘cross border’ charities.
  - In Northern Ireland, it will still need an audit or independent examination under the 2008 Act (NI) as determined by the relevant threshold in Northern Ireland charity law.

37. There are further complexities for groups with a charitable parent company. In England and Wales, for example:
- If the Companies Act 2006 requires the preparation of group accounts, these must be prepared and audited under that Act and no requirement arises for the group accounts to be prepared and audited under the 2011 Act (E&W). Under company law, group accounts must be prepared by the parent of medium-sized and large groups.
  - If the 2011 Act (E&W) requires a charitable company parent to prepare group accounts, these must be prepared under the Companies Act 2006 and prepared and audited under the 2011 Act (E&W). Under the 2011 Act (E&W), group accounts are required where the aggregate gross income of the group for the financial year exceeds £1 million. In this scenario, group accounts would be being prepared on a voluntary basis under the Companies Act 2006 and the parent could elect for audit exemption under company law.

### **Friendly Societies and Registered Societies**

38. This is a specialist area and reference should be made to the requirements of all applicable legislation. However, in Scotland and Northern Ireland friendly societies and registered societies must also comply with the external scrutiny requirements of applicable charity law.

## **OTHER ASPECTS OF LAW RELEVANT TO AUDITORS**

### **England and Wales**

#### **Content of auditor's report**

39. The Charities (Accounts and Reports) Regulations 2008 (as amended) set out the matters to be included in the auditor's report. In addition to giving an opinion on the state of affairs and incoming resources and their application and compliance with the regulations, additional statements in the auditor's report are required where the opinion is formed that:
- Proper accounting records have not been kept in accordance with Section 130 of the 2011 Act (E&W);
  - The statement of accounts does not accord with those records;
  - Any information contained in the statement of accounts is inconsistent in any material respect with any report of the charity trustees prepared under Section 162 of the 2011 Act (E&W) in respect of the financial year in question; or
  - Information and explanations considered necessary have not been provided.

#### **Access to information and explanations**

40. Auditors have a right of access with respect to books, documents and other records (however and wherever kept) relating to the charity concerned and any subsidiaries. The auditor is entitled to require, in relation to the charity, information and explanations from past or present charity trustees, or from past or present officers or employees of the charity.

#### **Other reporting duties**

41. The auditor is required by Sections 156 to 159 of the 2011 Act (E&W) to report to the CCEW in writing if, in connection with an audit of a charity, the auditor becomes aware of a matter of material significance to the CCEW's regulatory functions under Sections 46, 47 and 50 (inquiries) and 76 and 79 to 82 (power to act for protection of charities) of

the 2011 Act (E&W).<sup>102</sup> A similar reporting duty is imposed on independent examiners. For exempt charities Section 160 of the 2011 Act (E&W) transfers the reporting duty to the principal regulator.

42. Sections 156, 159 and 160 of the 2011 Act (E&W) provide a statutory discretion for the auditor to report any relevant matter to the CCEW, or if the charity is exempt to a principal regulator. Where there is no statutory duty to report, the auditor should consider if reporting such a matter is in the public interest or could usefully assist the CCEW in its activities.
43. In addition, when an auditor ceases for any reason to hold office it must send to the charity trustees a statement of circumstances connected with its ceasing to hold office, which it considers should be brought to the trustees' attention or, if it considers that there are no such circumstances, a statement that there are none. The auditor should consider on resignation if there is a duty to report a matter of material significance and, if not, whether to exercise their discretion to report a relevant matter to the CCEW.

## **Scotland**

### **Content of auditor's report – Charity law requirements**

44. The Charities Accounts (Scotland) Regulations 2006 Regulations (as amended) set out the matters to be included in the auditor's report. The auditor must give an opinion as follows:
  - Where Regulation 8 (of the 2006 Regulations (Scotland) (as amended)) applies, the statement of account complies with the regulatory requirements, gives a true and fair view of the state of affairs of the charity at the year end and of the incoming resources and application of resources during the year.
  - Where Regulation 9 applies, the statement of account complies with the regulatory requirements and properly presents the receipts and payments of the charity for the year and its statement of balances at the year end.

In addition, the auditor is required to make a statement where the opinion is formed that:

- The accounting records have not been kept in accordance with the 2005 Act (Scotland) and 2006 Regulations (Scotland) (as amended);
- The statement of account does not accord with those records;
- Any information contained in the statement of account is inconsistent in any material respect with any report of the charity trustees prepared under Section 44(1)(b) of the 2005 Act (Scotland) in respect of the financial year; or
- Any information or explanation to which the auditor is entitled under Regulation 13 has not been afforded to them.

### **Access to information and explanations**

45. The 2006 Regulations (Scotland) (as amended) provide that the auditor shall have the right of access at all times to the records of the relevant charity and shall be entitled to require such information and explanations from the present or former trustees as the auditor thinks necessary for the performance of the auditor's duties.

### **Other reporting duties**

46. Where an auditor ceases to hold office for any reason, Regulation 10 of 2006 Regulations (Scotland) (as amended) states that the auditor must include in its notice of resignation a statement as to any circumstances connected with its resignation which it

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<sup>102</sup> Detailed guidance on the audit implications of this duty is provided in the Section *Reporting matters of material significance to charity regulators* of this Practice Note.

considers should be brought to the trustees' attention, or a statement that there are none. If there are circumstances which it considers should be brought to the trustees' attention, the auditor should send a copy of the statement to OSCR.

47. The auditor is required by Section 46 of the 2005 Act (Scotland) to report to OSCR if, in connection with an audit of a charity, the auditor becomes aware of a matter of material significance to OSCR's regulatory functions under Sections 28, 30 or 31 of the 2005 Act (Scotland).<sup>103</sup> A similar reporting duty is placed on independent examiners.

## **Northern Ireland**

### **Content of auditor's report**

48. The Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 set out the matters to be included in the auditor's report. The auditor must give an opinion as follows:
- Whether the statement of accounts complies with the requirements of Regulations 8, 9 or 10, as applicable, and in particular whether the balance sheet gives a 'true and fair' view of the state of affairs of the charity at the end of the relevant financial year; and
  - In the case of a general charity, the statement of financial activities gives a 'true and fair' view of the total incoming resources and expenditure of resources of the charity in the relevant financial year.
49. In addition, the auditor is required to make a statement where the opinion is formed that:
- Accounting records have not been kept in respect of the charity in accordance with Section 63 of the 2008 Act (NI);
  - The statement of accounts does not accord with those records;
  - Any information contained in the statement of accounts is inconsistent in any material respect with any report of the charity trustees prepared under Section 68 of the 2008 Act (NI) in respect of the relevant financial year; or
  - Any information or explanation to which the auditor is entitled under Regulation 26 has not been afforded to the auditor.

### **Access to information and explanations**

50. An auditor has a right of access to any books, documents and other records (however kept) which relate to the charity concerned which the auditor considers it necessary to inspect for the purpose of carrying out the audit.
51. The auditor is entitled to require such information and explanations from past or present charity trustees of the charity, or from past or present officers or employees of the charity, as the auditor considers necessary for the purposes of carrying out the audit.

### **Other reporting duties**

52. The auditor is required by Section 67 of the 2008 Act (NI) to immediately make a written report to the CCNI, if in the course of acting as auditor, the auditor becomes aware of a matter relating to the activities or affairs of the charity, or of any connected institution or body, which the auditor has reasonable cause to believe is likely to be of material

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<sup>103</sup> Detailed guidance on the audit implications of this duty is provided in the Section *Reporting matters of material significance to charity regulators* of this Practice Note.



significance for the purposes of the exercise by the CCNI of its functions under Section 22 or 33 of the Charities Act 2008.<sup>104</sup>

### **Charitable companies**

53. If an audit is being undertaken solely under company law or under both company law and charity law, the Companies Act auditor's report requirements must be complied with.

### **Auditor's report addressees where the charity appoints the auditor**

#### *Charitable companies*

54. If an audit is undertaken solely under the Companies Act 2006, for example, if a charitable company in England and Wales is above the company law audit threshold, the auditor's report should be addressed solely to the company's members.
55. If an audit is being undertaken solely under charity law, for example, a charitable company is below the company law audit threshold and has elected for exemption under the Companies Act 2006 but is above the charity law audit threshold, the auditor's report should be addressed solely to the company's trustees.
56. If an audit is being undertaken under both charity law and company law, for example, the charitable company is above the charity law audit threshold and below the company law audit threshold but no election for exemption under the Companies Act 2006 has been taken, the auditor's report should be addressed to both the members and the trustees.

#### *Non-company charities*

57. The auditor's report for a non-company charity should normally be addressed solely to its trustees. However, for example, in Northern Ireland where the CCNI appoints the auditor, the auditor's report should be addressed solely to the CCNI.

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<sup>104</sup> Detailed guidance on the audit implications of this duty is provided in the Section *Reporting matters of material significance to charity regulators* of this Practice Note.



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