Charity Finance Group Invitation to Comment Response

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

August 2017

About CFG

Charity Finance Group (CFG) was founded in 1987. It is the charity that works to improve the financial leadership of charities, promote best practice, inspire change and help organisations to make the most out of their money so they can deliver the biggest possible impact for beneficiaries. CFG has over 1300 members and our members manage nearly £21 billion in charitable income. Our members work at the heart of the strategic development of their organisations, and are at the forefront of delivering a sustainable and efficient charity sector.

CFG hosts a regular Technical Accounting Forum which brings together, accountants, auditors and finance staff of charities to discuss the impact of accounting regulation, as well as, other issues impacting on charity accountants. CFG was also part of the working group that fed into the Practice Note 11: *The Audit of charities in the United Kingdom* (PN 11) draft. This response draws on the evidence collated in these meetings in addition to working closely with auditors and accountants.

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Motivation for responding to this exposure draft

The exposure draft of the updated PN 11 is timely by the Financial Reporting Council (FRC). Over CFG's many years of working with auditors and charity finance professions we know that making regulation that supports charities and their beneficiaries is important. Ensuring that this regulation is up to date and includes the necessary statutory requirements is essential. We are aware that the FRC has conducted extensive research to ensure that the exposure draft meets the needs of auditors. We commend the FRC for taking the steps needed to engage the sector throughout the process for revising PN 11.

It is crucial, that the new PN 11 is workable for auditors who work with a range of charities with different levels of income. A charity with an income just above the audit threshold may not be able access auditors with the consummate skills and experience of charity accounts, which larger charities are able to. It is important, therefore, that the PN 11 is a comprehensive resource for those that are not greatly experienced with charity accounting rules.

CFG understands that the FRC has produced an exposure draft for PN 11 due to changes to the legislative and regulatory framework and developments in account and audit framework, including the new Charities SORP FRS 102. There has been a significant increase in scrutiny from the media, the public and Parliament on the finances of charities. However it is important that PN 11 does not seek to turn auditors into policemen for the charity sector. Levels of evidence and due diligence required by auditors should be proportionate and based on the best judgement of auditors who have the experience of their clients and an understanding of the law.

Although the FRC's PN 11 is written for auditors, it is essential that charities voices are listened to. The relationship between charities and their auditors is an important one and the FRC should be careful that there is no undue stress or burden placed on either the charities or the auditors as the result of the changes in the PN 11 exposure draft. Auditors do not operate in a vacuum and their approaches to guidance will affect their charity clients.

It is within this framework that CFG believes that any changes to PN 11 should be carried out with an understanding of the impact of that any changes in PN 11 will have on charities and their relationship with their auditors as well as the potential cost.

Comments on the Exposure draft: PN 11

We commend the FRC for understanding that auditors and charities are often overburdened by ever increasing regulatory guidance. The reduction of PN 11 from 152 pages to 74 pages and removing repetitive material that is repeated in the relevant ISA itself, and removing material provided by the Charity Regulators, and the Charities SORP will greatly reduce the regulatory burden of both auditors and their clients. We also believe that this reduction should be communicated with auditors and charities as a way to encourage engagement with the document.

Comments on specific sections of the exposure draft:

Restricted funds

The guidance given around restricted funds in paragraphs 104 – 107 of the exposure draft is particularly useful. It is important that auditors who are new to charities, understand the unique nature of restricted funds in charity accounts and how an understanding of their nature is essential for determining whether a charity is a going concern. In the presentation of PN 11, we would welcome additional highlighting and focus on this area given the problems that those without a grounding in charity accounting rules may encounter.

Risk

We commend the FRC for their *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* section and Appendix 1 *Conditions and events that may indicate risks of material misstatement*. The clear explanation that different accounting requirements are needed for a charities constitution and relevant national jurisdiction is essential for auditors who have limited experience with charities. The Appendix 1 is also clear in listing examples of risks, especially ones that are unique to charities.

Going concern

We are aware that the FRC has placed particular importance on the guidance around Going Concern, particularly with recent changes to charity law and with the Public Administration and Constitutional Affairs Committee (PACAC) report on Kids Company emphasising the auditor's role in ensuring a charities legal reporting of their financial sustainability. .

It is important that the updated section on *Going concern* is clear that charities **are not by their nature, a financial high risk.** The FRC must ensure that the guidance does not give inexperienced auditors undue concern that all charities are high risk, thus increasing their auditing scope and transferring this cost onto the charity.

Related parties

We are concerned that the current guidance on related parties could create the risk of placing an excessive burden on the auditors and charities to provide personal details of trustees of charities. We support the Association of Charitable Foundations concerns that the risks of such guidance will create intrusive audit practices, deterring individuals from a diverse range of backgrounds from becoming trustees.

As the current draft states, charities are already required by the law in the Charities Act and by the Charity Commission to keep in place policies to identify related parties. Auditors should ensure that they are aware of these controls and their use by the charity. However, we are concerned that not enough emphasis as has been given by auditors to take these into account when searching for related party transactions. We would recommend that the guidance is amended to make clear that although auditors should inspect whatever documentation they consider necessary, they should also take into account their assessment of the strength of existing controls. This will ensure that the right balance is struck between ensuring compliance and preventing excessive burdens being placed on trustees and charities.

In addition to those records or documents that may, normally, 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).

We would also recommend that the FRC also highlights where Charities SORP guidance goes beyond the ISA definition, such as where a beneficiary could be a related party.

Communication with those charged with governance

With regards to paragraph 67 it is essential that this wording does not cause over reporting by auditors. We are aware that auditors prefer to use management letters to start a debate with trustees when there are needed changes with the charity's governance. The wording used in paragraph 67 makes it unclear whether auditors can have this initial dialogue before reporting to the appropriate charity regulator.

CFG has long since argued that hampering this relationship would produce a parallel reporting framework, between auditors, regulators and charities and creating unnecessary bureaucracy and duplication. It would also place undue strain on the collaborative nature of auditor and charity relationship, which is often essential to so many charities.

We would recommend that this paragraph 67 is reworded to prompt auditors to engage in a dialogue with their clients before reporting; rather than enforce a negative culture of over reporting on auditors.

Reading and considering the other information

We have concerns with guidance issued in paragraph 220 and additional procedures needed to verify financial statements. The example given, of an auditor needing to undertake further procedures around contradictory information from trustees' meeting and the annual report could place a unsustainable time burden on auditors, creating a greater financial and bureaucratic burden for charities. This would divert both time and resources away from charities and would undermine their ability to deliver their charitable aims.

We urge the FRC to change the wording to encourage auditors, if needed, to verify a sample of financial statements to see whether materiality has been misstated. It is unclear how far the FRC expects the due diligence of material statements to be taken.

Certain charities that rely heavily on volunteers and sporadic donations; it is unrealistic to expect auditors to be able to verify these figures, without placing unprecedented demand on auditors time and finances. It is essential that the FRC makes it clear that they only expect auditors to use their professional judgement and experience to determine which financial statements in the annual report need to be verified.

The narrative nature of the Trustee Annual Report's (TAR), especially compared to commercial reports, can make it unclear what figures are audited, and what are narrative figures. For auditors who have limited experience of auditing charities accounts, it is essential that the FRC provide clarity around the extent they expect auditors to scrutinise the relevant material when the TAR is produced.

The FRC's definition of *Other information* also requires greater clarity. We are aware that charities often favour narrative reporting over financial reporting and that charities are increasingly communicating financial information with their stakeholders in varied ways beyond the annual report, such as, impact reports, Chair reports, and social media channels.

Therefore, the FRC, needs to clarify whether their definition of '*Other information'* is purely statutory information in the Trustees Annual Report, of whether it includes other information that the auditors might be aware off through other means.

This is essential for charities that combine the role of accountants and auditors, therefore meaning that an auditor is likely to gain knowledge of financial materiality outside of the scope of their audit.

While we are aware that the FRC had made attempts to ensure that the exposure draft for PN 11 does not create additional work for auditors, it is important that this guidance is given in the context of an auditor with little knowledge of the financial running of charities.

The FRC must ensure and examine any examples given for auditors to use as a benchmark, so that the examples do not unnecessarily increase the auditors workload, which are in turn likely to pass on the additional costs to charities through increased fees.

As noted in CFG's Technical Accounting Forum, many auditors do not learn how to audit charities accounts until professionally needed, often leading to misunderstanding over the complexities and uniqueness of charity financial regulation as seen in the Charities SORP FRS 102 and other related guidance from the charity regulators and the Charities Act.

Conclusion

Overall, we commend the FRC for reducing the considerable length of the 2012 PN 11 and removing duplicating information. It is essential that any guidance provided for charity auditors is appropriate in length; giving auditors the knowledge they need to know while refraining from overburdening them, potentially passing this cost onto charities.

While we are aware that the FRC has conducted an impact assessment for the proposed revised PN 11 and have identified no additional costs resulting from the revised guidance, we are concerned that this impact assessment has neglected to assess charities whose income puts them close to the audit threshold. These charities are unlikely to have access to auditors who are charity specialists, and instead might rely on auditors with more commercial knowledge. It is essential the FRC strikes an appropriate balance between the levels of knowledge, skills and experience of different types of auditors that charities will use across the UK.

It is imperative to ensure that the guidance does not paint all charities as high risk organisations. Charities often operate in a unique environment, and auditors are not always well versed in this nature and challenges of this environment. Therefore, the FRC has to be careful that the guidance giving in the exposure draft of PN 11 does not result in inconsistent application by inexperienced auditors. This risk could be mitigated by ensuring that the language and content of the PN 11 is charity specific and is not a hangover from other, private sector guidance.

Any revisions to PN 11, or guidance issued by the FRC, should ensure that the relationship between auditors and charities is not damaged. The relationship between auditors and charities is different to that seen in the for-profit world. Auditors and accountants are a key part of collaborative relationships that charities use to ensure they are meeting their financial statutory requirements, while trying to achieve their charitable aims.

It also important that this guidance is not seen as the only communication with auditors, and that the FRC works with the Charity Commission, CFG and other interested bodies to ensure appropriate guidance and support is available for auditors.