

# PRACTICE NOTE 11 (Revised)

## THE AUDIT OF CHARITIES IN THE UNITED KINGDOM

| <i>Contents</i>   | <i>Page</i> |
|---|-------------|
| Preface   | 3           |
| Introduction  | 5           |
| Special considerations in the application of Auditing Standards                       |             |
| Responsibility  |             |
| SAS 100: Objective and general principles governing the audit of financial statements | 12          |
| SAS 110: Fraud and error  | 13          |
| SAS 120: Consideration of law and regulations   | 15          |
| SAS 130: The going concern basis in financial statements                              | 22          |
| SAS 140: Engagement letters   | 26          |
| SAS 160: Other information in documents containing audited financial statements       | 28          |
| <i>Planning, controlling and recording</i>  |             |
| SAS 200: Planning   | 30          |
| SAS 210: Knowledge of the business  | 31          |
| SAS 220: Materiality and the audit  | 33          |
| SAS 240: Quality control for audit work   | 35          |
| <i>Accounting systems and internal control</i>  |             |
| SAS 300: Accounting and internal control systems and audit risk assessments           | 38          |
| <i>Evidence</i>   |             |
| SAS 400: Audit evidence   | 46          |
| SAS 410: Analytical procedures  | 50          |
| SAS 420: Audit of accounting estimates  | 51          |
| SAS 440: Management representations   | 52          |
| SAS 450: Opening balances and comparatives  | 53          |

|          |  |    |
|----------|--|----|
| SAS 460: | Related parties                        | 54 |
| SAS 470: | Overall review of financial statements | 55 |
| SAS 480: | Service organisations                  | 57 |

### *Using the work of others*

|          |  |    |
|----------|--|----|
| SAS 510: | The relationship between principal auditors and other auditors | 59 |
|----------|--|----|

### *Reporting*

|          |  |    |
|----------|--|----|
| SAS 600: | Auditors' reports on financial statements                                    | 61 |
| SAS 610: | Communication of audit matters to those charged with governance              | 65 |
| SAS 620: | The auditors' right and duty to report to regulators in the financial sector | 66 |

|                                 |    |
|---------------------------------|----|
| Summarised financial statements | 75 |
|---------------------------------|----|

### *Appendices*

|     |   |     |
|-----|---|-----|
| 1.  | <i>Charity accounting and audit regulations in the United Kingdom</i>                     | 79  |
| 2.  | <i>List of publications</i>   | 94  |
| 3.  | <i>Example engagement letter for an unincorporated charity audit</i>                      | 97  |
| 4.  | <i>Example representation letter</i>  | 103 |
| 5.  | <i>Illustrative examples of auditors' reports on charities' financial statements</i>      | 105 |
| 6.  | <i>Example statements of trustees' responsibilities</i>                                   | 112 |
| 7.  | <i>Independent examination: comparison with audit</i>                                     | 114 |
| 8.  | <i>Examples of matters that would be routinely investigated by the Charity Commission</i> | 118 |
| 9.  | <i>Definitions</i>  | 123 |
| 10. | <i>Some significant topics relevant to audits of charities</i>                            | 129 |

|  |     |
|--|-----|
| <i>APB Statement of Standards for Reporting Accountants applicable to small (charitable) companies</i> | 131 |
|--|-----|

## **PREFACE**

This Practice Note contains guidance on the application of Auditing Standards issued by the Auditing Practices Board (APB) to the audit of charities in the United Kingdom.

The Practice Note is supplementary to, and should be read in conjunction with, Statements of Auditing Standards (SASs), which apply to all audits undertaken in the United Kingdom. Audits of charities where required by applicable legislation in the United Kingdom may only be carried out by registered auditors, or other persons authorised by statute or to whom the Charity Commission<sup>1</sup> may grant dispensation.

This Practice Note supersedes the guidance included in Practice Note 11 'The audit of charities' issued by the APB in October 1996, and takes account of significant regulatory developments affecting charities since PN 11 was issued, including:

- the re-issue in October 2000 of the Charities Statement of Recommended Practice : Accounting and Reporting by Charities (the Charities SORP), and
- the issue by the APB of new Standards – SASs 240(Revised) – Quality control for audit work, 480 – Service organisations, and 610(Revised) – Communication of audit matters to those charged with governance.

The guidance for auditors of unincorporated charities in England and Wales on their 'whistleblowing' responsibilities to the Charity Commission has been expanded, particularly by the insertion of a new Appendix 8 'Examples of matters that would be routinely investigated by the Charity Commission'.

The Practice Note is based on legislation and regulations in effect at 1 March 2002. The regulatory frameworks for charities in Scotland and Northern Ireland differ in some respects from that applicable in England and Wales, and it is important for auditors to understand which legislation is relevant to their client charities, and to what extent this is applicable to the conduct of their audit work. The Charities legislation applicable to each jurisdiction in the United Kingdom is described in detail in Appendix 1 - Charity accounting and audit regulations in the United Kingdom.

In addition to relevant charities legislation and regulations charities may be subject to other regulatory regimes. Auditors will need to be aware of the regulatory, accounting and auditing features imposed by these other regimes. Examples of bodies which, when constituted as charities, may be subject to additional accounting requirements include companies, housing associations, friendly societies, and universities. Statements of Recommended Practice (SORPs) are issued in relation to a number of such sectors, and need to be taken into account in preparing charities' financial statements. In addition, charities are affected by the whole

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<sup>1</sup> The regulatory body for charities in England & Wales.

range of national legislation applicable to business entities, such as employment and pensions law, health and safety regulations and tax law.

This Practice Note has been prepared in consultation with staff of the Charity Commission for England and Wales, the Scottish Executive, and the Department for Social Development in Northern Ireland.

## **INTRODUCTION**

1. The purpose of this Practice Note is to give guidance on the application of Statements of Auditing Standards (SASs) to the audit of charities in the United Kingdom. SASs contain the basic principles and essential procedures, referred to as Auditing Standards, which are indicated in the text of the SASs by bold type and with which auditors are required to comply, except where otherwise stated in the SAS concerned, in the conduct of any audit of financial statements.
2. Registered auditors are required to comply with Auditing Standards when conducting audits. This principle applies in the context of charities in the same way as to entities in any sector, irrespective of their size, but the way in which Auditing Standards are applied needs to be adapted to suit the particular characteristics of the entity audited.
3. Auditing Standards include a requirement for auditors to comply with the ethical guidance issued by their relevant professional bodies in the conduct of any audit of financial statements. A fundamental principle embodied in such guidance is that practitioners should not accept or perform work which they are not competent to undertake unless they have the means of achieving competence. The importance of technical competence is also underlined in *The Auditors' Code*, issued by the APB, which states that the necessary degree of professional skill demands an understanding of financial reporting and business. Practitioners should not undertake the audit of charities unless they are satisfied that they have, or can obtain, the necessary level of competence.
4. This Practice Note sets out the special considerations relating to the audit of charities, including those in England and Wales that are 'exempt' or 'excepted', which arise from individual SASs listed in the contents. It is not the intention of the Practice Note to provide step-by-step guidance to the audit of charities, so where no special considerations arise from a particular SAS, no material is included.
5. In general, no statutory audit requirement exists for small charities, though a requirement to appoint an independent examiner (in the case of unincorporated charities) or a reporting accountant (in the case of charitable companies) may apply.
6. An independent examination is significantly different from an audit, and is not required to be undertaken by a qualified accountant or registered auditor. This Practice Note is intended to provide guidance on the conduct of audits of charities, but the main differences between an audit and an independent examination are set out in Appendix 7. Guidance on the conduct of independent examinations in England & Wales has also been published by The Charity Commission<sup>2</sup>.
7. Reporting accountants engaged to report on the financial statements of smaller

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2 Independent Examination of Charity Accounts, Directions and Guidance Notes.

charitable companies which are exempt from audit under sections 249A to 249E of the Companies Act 1985 follow the procedures for making audit exemption reports contained in the *Statement of Standards for Reporting Accountants* issued by the APB. This Statement is reproduced at the end of this Practice Note.

## **Legislative and regulatory framework**

### **The regulatory framework**

8. The regulatory framework for charities is complex, as different requirements exist depending on the part of the United Kingdom in which the charity is established and the type of activity which it undertakes. An understanding of the applicable regulatory jurisdiction and activities of the charity is, therefore, a pre-requisite of each audit. The Charity Commission is the regulator of charities in England and Wales, and its regulatory requirements are outlined in subsequent sections of this Practice Note. Where significant differences exist between the requirements of the Charity Commission and other regulatory bodies, the requirements applicable to charities established in Scotland and Northern Ireland are also noted. In this connection it should be noted that the recent review undertaken by the Company Law Review Steering Group may lead in due course to changes in the law applicable to charitable companies. In addition a review of charity law in Scotland<sup>3</sup> has been published, which may lead to changes in the regulation of charities in Scotland in due course. Appendix 1 to this Practice Note describes and compares the regulatory framework for each of the different jurisdictions in the United Kingdom.

9. The audit of charities is subject to special considerations because the majority of the sector is regulated. In addition to their primary objective of reporting on financial statements, auditors of charities in England and Wales may have an additional statutory duty to report in certain circumstances to the Charity Commission. This duty is discussed in the section giving guidance on SAS 620 The auditors' right and duty to report to regulators in the financial sector.

10. The Charity Commission has powers under section 18 of the Charities Act 1993 (the 1993 Act) to act for the protection of charity property belonging to a charity in England and Wales where in the course of an inquiry 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:

- suspension of any trustee, officer, agent or employee;
- appointment of additional trustees;
- removal of a trustee, officer, agent or employee;
- freezing of property, restrictions on transactions or payments; and

- appointment of a receiver and manager.

In Scotland the Lord Advocate, and in Northern Ireland the Department for Social Development, also have some, though more restricted, powers to intervene in a charity's affairs.

### **Charity governing documents**

11. The governing document of the charity may determine matters such as the scope of the audit engagement and the auditors' reporting considerations (which may supplement, but not derogate from, statutory requirements for audit). There is no such thing as a standard charity: the governing document of each charity is individual and will need careful review to identify particular charitable objects as well as any special powers conferred on the trustees.

12. Any transaction by a charity that is undertaken outside its stated objects is potentially a breach of trust. Such transactions require particular consideration, and where there is provision within the regulatory framework then the requirement to report the matter to the body with oversight of charities in the relevant jurisdiction needs to be considered. Non-compliance with the governing document is also likely to have financial implications for the charity, and thus needs to be taken into account in determining whether the financial statements give a true and fair view. 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 auditors are much more likely to be faced with a situation where a client charity has acted *ultra vires* or in breach of trust than would be the case with an entity in the commercial sector.

13. In general terms, charities may not amend their objects without reference to the relevant body unless they have explicit constitutional powers to do so. To obtain registration as a charity in England and Wales a charity must submit a copy of its governing document to the Charity Commission; any subsequent amendment must be notified and certain amendments may require the consent of the Charity Commission. Exempt charities cannot register, and excepted charities are not required to register, nor are very small charities. This does not affect the legal duties which apply to such charities; they still have to adhere to their objects and legal liabilities may still result if they fail to do so. Similarly, in Scotland it is the role of the Inland Revenue<sup>4</sup> to recognise charities and to consent to subsequent changes to the governing document.

14. Guidance on the effect the terms of governing documents may have on the audit is given in the section on SAS 120 Consideration of laws and regulations.

### **Accounting and audit requirements**

15. The financial statements of a charity which are prepared to give a true and fair view under the requirements of either the 1993 Act or the Companies Act 1985 are required to be

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<sup>4</sup> In accordance with s.1(7) of the law reform (Miscellaneous Provisions) (Scotland) Act 1990.

prepared in accordance with applicable law and regulations, Financial Reporting Standards, and Statements of Standard Accounting Practice, irrespective of whether they are subject to audit, independent examination or reporting under section 249A of the Companies Act. The Statement of Recommended Practice 'Accounting and Reporting by Charities' (the Charities SORP), issued by the Charity Commission in October 2000 and developed in accordance with the Accounting Standards Board's (ASB's) stated practice, supplements these general accounting principles and is intended to apply to all charities in the United Kingdom and the Republic of Ireland (unless a separate SORP exists for a particular class of charities) regardless of their size, constitution or complexity and indicates the current view of best practice in accounting for charities. In addition, FRS 18- Accounting Policies- requires a statement that financial statements have been prepared in accordance with the relevant SORP, and details of any departures from the recommended practice and disclosures. Consequently, it is normally necessary to follow the guidance set out in the Charities SORP in order to give a true and fair view, as required by both Acts<sup>5</sup>

16. Trustees of small unincorporated charities in England and Wales which are within the income thresholds defined by legislation may elect to prepare financial statements on a receipts and payments basis. In Scotland, the trustees can elect to do this if there is no requirement in the trust deed for audited accounts. Financial statements prepared on this basis are not required to give a true and fair view. Separate guides on the preparation of financial statements on this basis are available from the Charity Commission and the Scottish Council for Voluntary Organisations.

17. 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. Smaller unincorporated charities may be entitled to submit their financial statements to independent examination; charitable companies may be able to claim entitlement to an audit exemption report under section 249A of the Companies Act; very small or certain other charities may be totally free from any external review requirements. The nature of the work to be undertaken, if any, depends on the constitution, activity and size of the charity, as well as the jurisdiction in which it is established.

18. In addition to reports required by statute, auditors of charities may be requested to provide additional reports in relation to grant-funded projects, giving assurance on matters such as the proper use of money and costs to completion. This Practice Note does not cover such additional engagements.

### **Special features of charities**

19. Auditors may be required to audit a great diversity of charities in terms of constitution, activity and size. The smallest will be local, single activity operations run by trustees who do not necessarily have any financial expertise, whereas the largest may be international concerns with multiple activities, employing many full-time professional staff and operating

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5 See Paragraph 194.

sophisticated accounting systems. The following paragraphs describe some of the key areas which are particular to the audit of charities.

### ***Sources of income***

20. A common feature of most charities is the receipt of voluntary income, which may be received by way of cash donations or donations in kind. Unlike the income of commercial entities, voluntary income will not always be supported by invoices or equivalent documentation. Obtaining assurance as to the completeness and accuracy of recorded donations can therefore be difficult.

21. The level of income from donations cannot be predicted with any great accuracy, as people's pattern of giving may change due, for example, to economic hardship or competing demands on limited resources. It is also difficult to establish a relationship between donations and other figures in the financial statements, as expenditure levels may not have any direct relationship with such income. Where voluntary 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, and the charity's auditors are likely to rely on evidence concerning those controls in order to form a view on the completeness of the income shown in its financial statements.

22. The Charities SORP states that incoming resources should be recognised when prudent and practical. Recognition is dependent on legal entitlement, reasonable certainty of receipt and the monetary value being measurable with reasonable certainty. The use of autonomous branches, agents or loosely affiliated volunteer groups for fund-raising needs to be considered when determining the appropriate method of income recognition. Auditors of a charity need to understand clearly the basis and terms on which such fund-raising services are provided to it.

23. Other sources of income include grants, for example from public authorities or other charities. Such grants are usually made for specific purposes and are subject to conditions, breach of which can have serious implications for the charity. Developments in the public sector mean that auditors of a public authority donor may have, or seek, the right of access to the charity's records to follow through and verify the use made of the grant. In addition grants from public bodies are often, and increasingly, subject to clawback provisions requiring repayment if a charity breaches specified conditions.

24. Further guidance is given in the sections on SAS 300 Accounting and internal control systems and audit risk assessments, and SAS 400 Audit evidence.

### ***Restricted funds***

25. The definition of restricted funds is set out in Appendix 9 to this Practice Note. Restricted funds must not be used for general purposes; if such funds are used other than in the way specified, the trustees of the charity will have breached their duty. The Charities SORP also indicates that such funds are to be separately disclosed in the charity's financial statements. Consequently, auditors consider whether restrictions are likely to exist as part of their planning

process and when assessing the presentation of funds in a charity's balance sheet. Auditors also establish whether they may be requested to issue a special report in respect of grants or restricted funds.

26. The sections on SAS 120 Consideration of law and regulations and SAS 220 Materiality include further comment on this issue.

### ***Trading, charitable status and taxation***

27. The existence of trading activities needs to be taken into account during the planning of a charity's audit and in relation to the charity's compliance with laws and regulations and, where appropriate, in England and Wales the auditors' statutory duty to report to the Charity Commission. Trading by charities falls into two main categories: primary purpose trading and trading to raise funds for charitable purposes.

28. Primary purpose trading is the exercise of a trade in the course of the actual carrying out of a primary purpose of a charity, for example the charging of fees by a school which is established as a charity for the advancement of education. The category of 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.

29. Trading for fund-raising 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. If a relevant power exists a charity may trade on a small scale for fund-raising purposes. The usual test for permissibility (although not invariably) is whether the profits of the trade fall within the tax exemptions for small trading activities or the concessional relief for fund raising activities. If the entity actually has the power to engage in unlimited or substantial trading activities for the purpose of raising funds it will not be a charity.

30. 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 fund-raising purposes can fall within the wider 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.

31. The taxation treatment of trading by charities is dealt with in more detail in the section on SAS 120 Consideration of law and regulations.

### ***Operating structures and branches***

32. Charities can adopt a variety of organisational structures including:

- a single centrally-administered organisation,

- a centrally-administered organisation with branches both in the UK and overseas, and
- a parent charity with a group structure including subsidiaries, joint ventures and associates.

The Charities SORP requires branches (as defined in Appendix 9 of this Practice Note) to be accounted for in the entity's financial statements and for consolidated financial statements to be prepared in group situations.

33. The auditors of a charity are responsible for forming an opinion on all the charity's operations, including UK and overseas branches. Auditors take steps to ensure that sufficient appropriate audit evidence is obtained in relation to material branches and subsidiaries. Evidence may be available from the work of internal audit or from the work of another audit firm.

### **The public interest**

34. A greater public interest in the accountability of charities exists than in that of commercial enterprises of a similar size because their purpose is to serve some public good as opposed to being in business for profit. The principal source of income for many charities is voluntary donations by members of the public, who receive no direct benefit in return. Misuse of the funds so given represents a breach of donors' trust which could result in their decision not to make further donations to a particular charity. Even where charities do not rely on public donations because they are richly endowed or have substantial investments, misdirection of their funds means that their objects will suffer the shortfall.

35. The nature and extent of the public interest in individual charities will depend on their constitution, size and activities and has a pervasive effect on the audit of charities. Public interest in charities which are small, local, grant-making bodies may be limited to the area of their operation. At the other end of the scale are very large charities whose operations are national or even international, with a commensurate impact on society.

36. Charities may be responsible for public money, that is, money raised by government (whether local or central) through taxation or other means, such as the National Lottery. This means that there is a public interest in ensuring the accuracy, reliability, and availability of information about charities' activities and the use of their resources. The tax concessions, in respect both of direct and indirect taxation from which charities can benefit, also represent an indirect application of public money.

# **SPECIAL CONSIDERATIONS IN THE APPLICATION OF AUDITING STANDARDS**

Statements of Auditing Standards (SASs) apply to the conduct of all audits. This includes all audits of charities' financial statements, irrespective of the size, activity, or organisation of the charity audited. The purpose of the following paragraphs is to identify the special considerations arising from the application of individual SASs to the audit of charities. Where no special considerations arise from a particular SAS, no material is included.

## **RESPONSIBILITY**

### **SAS 100: OBJECTIVE AND GENERAL PRINCIPLES GOVERNING THE AUDIT OF FINANCIAL STATEMENTS**

#### **Background note**

*In undertaking an audit of financial statements, SAS 100 requires that auditors carry out procedures designed to obtain sufficient appropriate evidence, in accordance with Auditing Standards, to determine with reasonable confidence that the financial statements are free from material misstatement. The SAS also requires that auditors should evaluate the overall presentation of the financial statements to ascertain that they have been prepared in accordance with relevant legislation and accounting standards. The SAS requires that auditors should issue a report containing a clear expression of their opinion on the financial statements.*

*SAS 100 requires that auditors should comply with the ethical guidance issued by their relevant professional bodies in the conduct of any audit of financial statements.*

37. Auditors are required to exercise their professional judgment within the framework provided by Auditing Standards to determine the extent of work necessary, in a particular instance, to provide reasonable assurance that the financial statements, taken as a whole, are free from material misstatement.

38. The accounting requirements under which charities report depend on how they are constituted and the relevant national jurisdiction within the United Kingdom. The principal categories are as follows:

- unincorporated charities in England and Wales- the 1993 Act;
- unincorporated charities in Scotland -the Law Reform ( Miscellaneous Provisions) (Scotland) Act 1990;
- charitable companies- the Companies Act 1985;

- exempt charities – dependent on how they are constituted and on any specific statutes or regulations that apply to them.

The Charities SORP applies to all charities in the United Kingdom however constituted (unless a more specialist SORP exists for a particular class of charities) that are required to prepare financial statements giving a “true and fair” view.

39. Where a charity’s financial statements are required by statute to give a true and fair view of its income and expenditure (incoming resources and their application) and of its state of affairs, compliance with applicable accounting standards issued by the Accounting Standards Board is normally necessary to meet this requirement.

## **SAS 110: FRAUD AND ERROR**

### **Background note**

*The SAS requires that auditors should plan and perform their audit procedures, and evaluate and report on the results thereof, recognising that fraud or error may materially affect the financial statements. The SAS requires that, when planning the audit, auditors should assess the risk that fraud or error may cause the financial statements to contain material misstatements. Based on their risk assessment, auditors should design audit procedures so as to have a reasonable expectation of detecting misstatements arising from fraud or error which are material to the financial statements.*

### **The regulatory framework**

40. The regulatory framework within which a charity operates does not alter the nature of the auditors’ responsibility to consider fraud and error in an audit of financial statements as described by SAS 110. However, the framework does affect the circumstances in which the auditors report to third parties, the form of the report and the persons or bodies to whom the report is made. The section providing guidance on SAS 620 deals with reports to the regulators of charities.

### **Special features of charities**

41. 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. They are expected to safeguard charity assets and revenues through the implementation of appropriate systems of control. The auditors of a charity are responsible for forming an opinion as to whether financial statements show a true and fair view and to this end they plan, perform and evaluate audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from error or fraud.

42. Certain features of charities may increase the risk of fraud or error. These include:

- widespread branches or operations, including, for example, aid agencies established in response to emergency appeals in distant countries where there is no effective system of law and order;
- the use of volunteer and/or inexperienced staff;
- 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.

Guidance on the internal control procedures, which can be put in place by trustees and are designed to minimise the risk of fraud or error occurring, is included in the section on SAS 300, Accounting and internal control systems and audit risk assessments.

## ***Reporting suspected fraud or error***

### ***(1) reporting to management***

43. SAS 110 requires auditors to communicate their findings to ‘the appropriate level of management’, unless the suspected or actual instance of fraud casts doubt on the integrity of the directors or equivalents (in a charity, the trustees). In this case, ‘the auditors should make a report direct to a proper authority in the public interest, without delay and without informing the directors in advance’ (SAS 110.12).

44. In the case of charities 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 fraud, the auditors may consider that it is appropriate to communicate with the trustees in the first instance. In this case SAS 110.7 requires auditors to communicate their findings as soon as practicable.

### ***(2) reporting to the addressees of the auditors’ report on the financial statements***

45. Even where the addressees of the auditors’ report are the trustees, and the auditors suspect them of involvement in a fraud or are aware that the matter has already been communicated fully to them, their report on the financial statements is required to include details of any fundamental uncertainty, or disagreement over disclosure of a suspected or actual instance of fraud or error having a material effect on the financial statements, in accordance with SASs 110.8 and 110.9 respectively. In the case of a charitable company, the auditors’ report is addressed to the members of the company, who may not all be trustees.

### ***(3) reporting to third parties***

46. SASs 110.10 to 110.12 deal with the reporting of actual or suspected frauds to third parties, in particular reporting to a ‘proper authority’ in the public interest. The SAS states that the auditors should only report to an authority ‘with a proper interest to receive the information’.

47. In the case of charities, the proper authority is ordinarily the Charity Commission for charities established in England and Wales (other than exempt charities), the Scottish Charities Office for charities based in Scotland, the Charities Branch of the Department for Social Development for charities in Northern Ireland, and, in any part of the United Kingdom, the Police.

48. Charities undertake a wide range of activities (some of which are themselves regulated). Where a charity is subject to a regulatory regime in addition to that resulting from its charitable status, its auditors assess whether to report a suspected fraud to the relevant other regulator. For example, in England and Wales 'exempt' charities are subject to other regulatory authorities, which may be regarded as proper authorities for the purpose of SAS 110: for example certain universities, or grant maintained schools in England and Wales, which are regulated by the Department for Education and Employment (or its agencies) as the funding authority; other charities throughout the United Kingdom may be registered friendly societies, whose auditors have a statutory duty to report to the Financial Services Authority.

49. Auditors of unincorporated charities in England & Wales have a statutory duty to report to the Charity Commission in certain circumstances, as set out in the section dealing with the application to charities of SAS 620 The auditors' right and duty to report to regulators in the financial sector. It is unlikely that auditors of such charities will encounter suspected frauds of sufficient gravity to consider reporting in the public interest which do not also give rise to a statutory duty to report.

## **SAS 120: CONSIDERATION OF LAW AND REGULATIONS**

### **Background note**

*The SAS requires that auditors plan and perform their audit procedures and evaluate and report on the results thereof, recognising that non-compliance by an entity with law or regulations may materially affect the financial statements.*

*The SAS requires that auditors should obtain sufficient appropriate audit evidence about compliance with those laws and regulations which relate directly to the preparation of, or the inclusion or disclosure of specific items in, the financial statements.*

*The SAS requires that the auditors should perform specified procedures to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and hence to its financial statements.*

*The SAS requires that, when carrying out their procedures for the purposes of forming an opinion on the financial statements, the auditors should in addition be alert for any instances of possible or actual non-compliance with law or regulations which may affect the financial statements.*

50. The SAS requires auditors to be alert for instances of possible or actual non-compliance with laws and regulations. In the case of charities, relevant laws and regulations include trust law, and hence specific requirements as to the use of restricted funds and preservation of any permanent endowments (capital funds).

### ***The regulatory framework and charity governing documents***

51. The trustees of a charity are responsible for ensuring that the necessary controls are in place to ensure compliance with applicable law 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.

52. The regulatory framework within which a charity operates does not alter the nature of the auditors' responsibility to consider law and regulations in an audit of financial statements as described by SAS 120. However, auditors' planning and procedures are shaped by laws and regulations specifically made to cover charities, as well as laws which affect charities when they undertake certain activities such as fund-raising.

### ***Classification of laws and regulations***

53. SAS 120 states that laws and regulations<sup>6</sup> relevant to the audit can be regarded as falling into two main categories:

- (a) those *relating directly to the preparation of the entity's financial statements*, or the inclusion or disclosure of specific items in the financial statements; and
- (b) those which provide a legal framework within which the entity conducts its business and which are *central to the entity's ability to conduct its business* and hence to its financial statements.

54. Examples of items falling into each of these two categories are discussed in the following paragraphs. Laws and regulations which do not fall into either category need not be taken into account in planning audit work to be undertaken: however, auditors are required to remain alert to the possibility of breaches of other requirements and to investigate any which come to their attention<sup>7</sup>.

### ***Laws relating directly to the preparation of the financial statements***

55. In addition to requiring the auditors to obtain sufficient appropriate audit evidence about compliance with laws and regulations relating directly to the preparation of the financial statements, the SAS also indicates that auditors need to obtain evidence relating to compliance with laws and regulations where there is a statutory requirement for auditors to report, as part of the audit of financial statements, on whether the entity complies with those provisions.

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6 Guidance on the legislation applicable to charities is set out in Appendix 1

7 SAS 120.4 and 120.5.

56. Laws and regulations which relate directly to the preparation of financial statements for unincorporated charities are contained in the relevant legislation and subordinate regulations<sup>8</sup> relating to the particular UK jurisdiction in which the charity is based. Details of these appear in the section of this Practice Note on SAS 600. Where individual charities are subject to legislation other than specific charity legislation, for example charitable companies or charitable housing associations, there may be certain additional disclosure requirements.

57. In all three jurisdictions of the United Kingdom, it is normally necessary to follow the requirements of the Charities SORP in order to give a true and fair view. As a basis for forming an opinion as to whether accounts show a true and fair view and have been properly prepared, auditors therefore ensure that they are familiar with the Charities SORP, as well as with applicable regulations governing the form and content of accounts and annual reports by charities of England & Wales, Scotland, and Northern Ireland.

58. Auditors also check whether charities' governing documents contain any special provisions as to the disclosure of information in the financial statements or reporting requirements for the auditors. Users of the financial statements of a charity reasonably expect that the transactions recorded within them are authorised by the governing document 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 non-compliance with the governing document.

59. Auditors therefore familiarise themselves with charities' governing documents and in planning and conducting their audit:

- ensure that their audit procedures cover compliance with the governing document;
- consider any changes in the charity's activities proposed by the trustees to ensure that these comply with the governing document; and
- are alert to new or unusual transactions which may not be in accordance with the governing document.

### ***Laws which are central to the charity's conduct of its business***

60. SAS 120.3 requires auditors to carry out specified steps to help identify possible or actual instances of non-compliance with those laws and regulations which fall into the category of those central to the entity's ability to conduct its business.

61. 'Central' is described in the SAS as relating to those laws and regulations where

- (a) compliance is a pre-requisite of obtaining a licence to operate; or
- (b) non-compliance may reasonably be expected to result in the entity ceasing operations,

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<sup>8</sup> In England and Wales these are the Charities (Accounts and Reports) Regulations 2000. In Scotland these are the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 and the Charities Accounts (Scotland) Regulations 1992.

or call into question the entity's status as a going concern<sup>9</sup>.

62. In the context of charities, these two criteria indicate that laws and regulations are central to a charity when breaches would have any of the following consequences:

In England and Wales only:

- (a) appointment by the Charity Commission of a receiver and manager, or equivalent action in other jurisdictions (primarily breaches of laws and regulations applying to charities generally);
- (b) removal, replacement or suspension of the trustee body or majority of trustees by Charity Commission Order;
- (c) imposition of a scheme by the Charity Commission for the administration of the charity that significantly amends the activities or management of the charity;
- (d) presentation of a petition under section 63 of the Act for the winding up of a charitable company;
- (e) an order by the Charity Commission to restrict material transactions that may be entered into;

In the United Kingdom:

- (f) loss of necessary licences to continue a major element of the charity's work (primarily laws and regulation applicable to certain types of activity, for example, legislation applicable to children's homes); or
- (g) financial effects resulting in liabilities which are likely to exceed the available resources of the charity.

Determination of laws and regulations which are central to a particular charity therefore requires consideration of its governing document, 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, auditors also inspect any recent correspondence between the charity and the Charity Commission (or equivalent regulator) in accordance with the provisions of SAS 120.3.

63. In addition, each charity is bound to comply with the terms of its governing document, which may, for example, take the form of a trust deed, a will, a constitution or the Memorandum and Articles of Association of a company. The governing document sets out the objects of the charity and determines the powers of its trustees, and may also set out more detailed rules for conducting its work. Failure to comply with the governing document's terms

may constitute a breach of trust and, in particular, in England and Wales may form grounds for intervention by the Charity Commission.

64. The charity sector is diverse in terms of activities undertaken and hence the requirements of laws and regulations that are central to a charity's ability to operate are likely to be derived from the activities undertaken as well as arising from charitable status. For example charities providing residential care in England and Wales will be subject to the requirements of the Registered Homes Act 1984, and those in England and Wales providing residential accommodation for children will be subject to the provisions of the Children Act 1989. Significant regulatory breaches can result in loss of registration and hence ability to undertake particular activities. Similar legislative requirements can affect charitable operations in different parts of the sector and in the different parts of the United Kingdom.

65. The auditors 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, is not central to a charity's ability to achieve its objectives and to operate then auditors have no responsibility for considering whether such laws and regulations have been observed.

66. Breaches of laws and regulations which apply to a particular type of activity may also result in fines, the financial consequences of which may, in particular instances, be significant. Severe financial consequences may also arise from failure to comply with grant conditions (see also para 86) or taxation law.

67. Whilst charities do not enjoy a general exemption from taxation, there are significant direct tax exemptions available to charities both in relation to income and chargeable gains. Auditors need to have an understanding of these statutory exemptions and extra-statutory concessions in order to identify incoming resources that may fall outside their scope. Where income is receivable that does not fall within such reliefs, a charity can be exposed to significant tax liabilities. Substantial permanent trading for fund-raising purposes would also be incompatible with charitable status, and generally such trades would be hived off to a wholly-owned subsidiary company. Similarly, 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 conduct its business.

68. Where appropriate, auditors will consider charity - specific tax legislation or concessional reliefs<sup>10</sup>. These may include:

- income exemptions granted by the Income and Corporation Taxes Act (ICTA) 1988, s505;

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<sup>10</sup> See Inland Revenue Leaflet – IR 2001 Trading by Charities, Charity Commission leaflets CC.35 Charities and Trading and CC.20 Charities and Fund-raising.

- trades that will fall within the 'primary purpose' trading category (undertaken to achieve a primary purpose of the charity);
- trades that are carried out mainly by beneficiaries of the charity;
- trades that may enjoy exemption as being ancillary to a primary purpose trade;
- lawful lotteries<sup>11</sup>;
- exemption for small trading activities<sup>12</sup>;
- relief for fund-raising activities<sup>13</sup>;
- mandatory and discretionary rate reliefs;
- treatment of mixed trades, which are not wholly, primary purpose trades;
- capital gains tax exemption granted by the Capital Gains Taxes Act (CGTA) 1992 s256; and
- value added tax.

The auditors will also consider whether income and gains are applied to a charitable purpose to ensure that tax relief is not jeopardised. An application of funds outside the charity's own objects will also give rise to consideration of a breach of trust<sup>14</sup>.

69. Charities have no general exemption from VAT, but there are a number of specific exemptions and zero-rating treatments which apply to them<sup>15</sup>. The auditors have regard to these special exemptions and treatments which may be available in relation to supplies by and to the charity. Non-compliance or errors could have adverse financial consequences for the charity.

### ***Money Laundering and Terrorist Activities***

70. The Terrorist Act 2000 requires persons engaged in a profession to communicate to the Police any belief or suspicion of an offence committed under Sections 15 to 18 of the Act. These offences include fundraising, use of property, funding or money laundering in support of terrorism. Where auditors have suspicions of money laundering activities relating to drug trafficking, crime or terrorism they should refer to Practice Note 12 –Money laundering- for further guidance on reporting such matters to NCIS. In England and Wales auditors of unincorporated charities also have a separate statutory duty to report matters of " material

11 Promoted and conducted in accordance with section 3 or 5 of the Lotteries and Amusements Act 1976.

12 Finance Act 2000 section 46.

13 See Inland Revenue booklet - CWL4 Fund raising events: exemption for charities and other qualifying bodies.

14 The auditors will have an understanding of Finance Act 2000 section 46 and ICTA 1988 s 506 in relation to qualifying expenditure and Schedule 20 in relation to qualifying investments and loans. A failure to apply or invest income within these parameters may result in significant tax liabilities.

15 These are set out in particular in Schedule 8, Groups 4, 5, 6, 8, 12, 15; Schedule 9, Groups 6, 7, 9 and 12, Value Added Tax Act 1994 and SI 2000 no.805.

significance" to the Charity Commission's regulatory function ( see Practice Note section on SAS 620). Where an auditor has reasonable cause to believe the reported matter involves a charity or its trustees then such matters would normally also be regarded as being of material significance to the Charity Commission and would therefore give rise to an additional reporting duty. NCIS have advised that reporting to the Charity Commission in accordance with the statutory duty will not constitute "tipping off."

### ***Reporting non-compliance with laws and regulations***

71. SAS 120 provides guidance on action to be taken by auditors when possible non-compliance with laws and regulations is discovered. The procedures described in paragraphs 36 to 46 of the SAS apply to the audit of charities as to other entities, but there may be special reporting considerations, as set out below.

#### ***(1) reporting to management***

72. SAS 120 requires auditors to communicate their findings to the appropriate level of management, unless the suspected or actual instance of non-compliance casts doubt on the integrity of the trustees. In this case, SAS 120.15 requires auditors to make a report direct to a proper authority in the public interest, without delay and without informing the trustees in advance. In reporting to management auditors will be aware that trustees can be held accountable for any breach of the charity's trusts or neglect of their fiduciary duties. 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 law or regulations, the auditors may consider that it is appropriate to communicate with the trustees in the first instance.

#### ***(2) reporting to the addressees of the auditors' report on the financial statements***

73. The auditors' report on an unincorporated charity's financial statements is addressed to its trustees. Although an actual or suspected breach of relevant law or regulations may already have been reported to the trustees as managers of the charity (in accordance with SAS 120.8), the auditors nevertheless consider whether to include an additional explanatory paragraph describing a resulting uncertainty, if it is regarded as being fundamental, in their report on the charity's financial statements.

#### ***(3) reporting to third parties***

74. SASs 120.12 to 120.15 deal with the reporting of actual or suspected non-compliance to third parties, in particular reporting to a 'proper authority' in the public interest (see the section on SAS 110 for details of authorities in the charitable sector). Auditors of unincorporated charities in England and Wales have a statutory duty to report to the Charity Commission in certain circumstances, as set out in the section dealing with the application to charities of SAS 620. It is unlikely that auditors of such charities will encounter matters of sufficient gravity to consider reporting in the public interest which do not give rise to this statutory duty to report.

75. No equivalent duty applies to auditors of charities recognised under other UK jurisdictions, or to auditors of charitable companies. Auditors of such charities who become

aware of circumstances similar to those set out in the section on SAS 620 consider the need to report to an appropriate authority in the public interest, following the requirements of SAS 120. Paragraphs 65 to 69 of the SAS provide specific guidance on the factors to be taken into account in forming a judgment as to whether such a report is appropriate.

76. In forming a judgment auditors will be mindful that charities, however constituted, operate in the public interest. Where a regulator, such as the Charity Commission, has a statutory duty to investigate abuse then matters of material significance to this regulatory function will be indicative that such matters are of relevance to the public interest. Suspected or actual non-compliance with law and regulation identified by paragraph 65 of SAS 120 will include significant breaches of trust or duties placed on charity trustees. Appendix 8 sets out examples of matters that the Charity Commission would routinely investigate. Paragraphs 64 and 67 of SAS 120 explains the protection afforded to auditors from the risk of liability for breach of confidence or defamation in the context of public interest reporting.

## **SAS 130: THE GOING CONCERN BASIS IN FINANCIAL STATEMENTS**

### **Background note**

*The SAS requires that, when forming their opinion as to whether financial statements give a true and fair view, the auditors should consider the entity's ability to continue as a going concern, and any relevant disclosures in the financial statements.*

*The SAS requires that auditors should assess the adequacy of the means by which directors have satisfied themselves that it is appropriate for them to adopt the going concern basis and that the financial statements include such disclosures, if any, relating to going concern as are necessary for them to give a true and fair view. For this purpose, auditors should make enquiries of the directors, and examine appropriate available financial information. The auditors should also plan and perform procedures specifically designed to identify material matters which could indicate concern about the entity's ability to continue as a going concern, having regard to the future period to which the directors have paid particular attention in assessing going concern.*

*The SAS requires that the auditors should consider the need to obtain written confirmation of representations from the directors regarding the directors' assessment that the entity is a going concern, and any relevant disclosures in the financial statements.*

*The SAS requires that the auditors should consider whether the financial statements should include any disclosures relating to going concern in order to give a true and fair view.*

77. A charity should prepare its accounts on a going concern basis unless it is being

liquidated or has ceased operating or there is no realistic alternative but to liquidate or to cease its activities. The Charities SORP reiterates the relevance of this concept in the preparation of charity accounts which are intended to show a true and fair view. FRS 18 requires trustees, when preparing financial statements, to assess whether there are significant doubts as to the charity's ability to continue as a going concern.

### **Basis for preparation of financial statements**

78. 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. Auditors consider the availability of future funding and whether uncertainties exist which require disclosure in the financial statements. 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.

79. The going concern concept does not apply to the preparation of financial statements on a receipts and payments basis. When reporting on receipts and payments, however, the auditors still consider whether there are any matters affecting the charity's ability to continue as a going concern. They may become aware of funding difficulties which indicate that the charity will not be able to continue in operational existence for the foreseeable future. In such circumstances the auditors may not agree to issue their report unless they are satisfied with explanations provided by the trustees concerning future funding arrangements. If no satisfactory explanations are provided, the auditors may consider it appropriate to include an explanatory paragraph in their report. They do not, however, qualify their opinion on the proper presentation of the receipts and payment account.

### **Circumstances where a charity may not be a going concern**

80. The following list gives examples of conditions that can give grounds for concern that a charity may not be a going concern:

- inability to finance its operations from its own resources;
- decision by the trustees to curtail or cease activities;
- transfer to, or take-over by, another entity of the charity's activities;
- loss of essential resources or key staff;
- existence of tax liabilities which cannot be met from existing resources;
- deficits on unrestricted funds;
- loss of clients, for example where a public authority ends a practice or contract to refer (and pay for) clients to the charity;
- loss of operating licence (for example, for a residential care home);
- significant changes in strategy of major funders; and

- significant decline in donations by the public.

81. The examples of indicators contained in paragraph 31 of SAS 130 apply as much to charities as to commercial entities and include pointers such as an excess of liabilities over assets. 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 auditors rely solely on the existence of goodwill as evidence to support the going concern assumption.

### ***The operations of charities***

82. 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 auditors consider the income sources, their regularity and predictability and the degree of risk attaching to such sources.

83. The auditors may gain an understanding of the charity's perception of such risks by considering any reserves policy set by the charity trustees. Charities may see themselves as competing for scarce resources, particularly where a number of charities are operating in the same sector or area of activities. Other factors outside the control of a charity may also impact on cash flows such as constraints on spending by members of the public, either through loss of personal income, or a change in spending patterns. Factors for consideration may include:

- the level of regular or predictable giving – planned giving schemes such as gift aid and payroll giving,
- the income derived from investments or endowed funds,
- the diversity of fund-raising initiatives,
- the past record, pattern and infra-structure of fundraising activities,
- the level of dependence on a particular source of funding whether an individual or an institution, and
- dependence on particular contracts and their renewal.

84. 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, 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 auditors consider may include:

- the nature and impact of the restrictions placed on the use of any material restricted income funds,
- the liquidity of assets held within restricted income funds,

- the 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, and
- the operational ability to withdraw from projects or activities which have been subject to fund designations.

85. 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 re-imburses 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,
- funding of long-term projects based only on short-term commitments as to funding receivable, and
- 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.

86. 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. For example, a charitable housing association providing supported housing may lose its grant from the Housing Corporation if it fails to comply with the relevant grant conditions. Many charities rely on public authorities for grant support, or for referral and funding of clients. Where the financial effect of withdrawal of funding would be fundamental to a particular charity, auditors assess whether compliance with grant conditions has been achieved or otherwise obtain evidence about steps taken by the trustees to ensure compliance.

### ***Obtaining evidence***

87. Under SAS 130 the auditors' opinion on the financial statements is only qualified if they consider that the scope of their work is limited due to inadequate or inappropriate consideration of going concern by the trustees, or that there is insufficient disclosure of relevant circumstances to enable the financial statements to give a true and fair view, or that the basis used in the preparation of the financial statements was inappropriate. Where there is fundamental uncertainty about the future viability of the charity, but the auditors consider that both the measures taken by the trustees in relation to assessment of going concern and disclosure of any matters needed for a proper understanding of the circumstances were adequate, their opinion would not be qualified in respect of going concern. In these

circumstances, the auditors include an explanatory paragraph in the basis of opinion section of their report.

88. In considering going concern, it may be helpful for the auditors to include the following points in discussions with trustees:

- the reliability of the budget and cash-flow forecast for the coming year, based on past experience and the certainty of inflows and outflows ;
- the nature of management information systems covering future income and expenditure;
- 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, whether it would be practical to obtain a degree of comfort from such funders as to their future support for the charity;
- shortfall of identifiable future income on forecast expenditure needing to be made up by voluntary donations of cash or other resources;
- lists of projects supported or awards made in the year and planned for the following year;
- the level of uncommitted reserves remaining available to the charity;
- any reliance on support by the charity's bankers, major donors, or public authorities;
- concentration on provision of services to a particular category of beneficiaries or objects for which future funding or demand may be limited; and
- any special operating licences or similar conditions.

## **SAS 140: ENGAGEMENT LETTERS**

### **Background note**

*The SAS requires that the auditors and the client should agree on the terms of the engagement, which should be recorded in writing. Auditors should agree the terms of their engagement with new clients in writing. Thereafter auditors should regularly review the terms of engagement and, if appropriate, agree any updating in writing.*

*The SAS requires that auditors should confirm in the engagement letter their acceptance of the appointment and include a summary of the respective responsibilities of directors ( in charities, the trustees) and auditors, the scope of the engagement and the form of any reports.*

89. The basic principles used in drafting engagement letters apply in relation to the audit of charities as to the audit of any entity. Practical considerations arising from the particular

characteristics of charities are considered below.

### ***Addressee***

90. In all cases engagement letters should be addressed to the charity trustees. If the trustees are not engaged in the day-to-day running of the charity, the auditors may wish to send an additional copy of the engagement letter to the chief executive or the persons responsible for its day-to-day management.

### ***The operation of charities***

91. Where charities are in receipt of restricted income such as government or local authority grants, the auditors discuss with the trustees any special reports required by donors. Even where auditors are not aware of any such requirements, they may consider it appropriate to enquire of the trustees whether any reports are required in addition to their report on the charity's financial statements. However, it is the responsibility of the trustees to identify the need for any additional reports and to instruct the auditors accordingly: it will not be practicable for the auditors to check the documentation relating to all funds received by the charity to identify any conditions requiring special reports.

92. In England and Wales auditors of unincorporated charities will normally refer in their engagement letter to their statutory duty to report to the Charity Commissioners any matters of which they become aware that may be of material significance to the Commissioners. Whilst this statutory duty is not applicable in the case of audits of charitable companies in England and Wales, auditors may wish to advise the trustees of the possibility that circumstances may arise that will cause them to report to an appropriate authority in the public interest.

93. In the other parts of the United Kingdom, where there is no specific requirement to report, auditors who come across circumstances similar to those giving rise to the statutory duty to report to the Charity Commission (see Appendix 8) consider whether to report to an appropriate authority in the public interest. Auditors may wish to make reference to this circumstance and its consideration in the letter of engagement. Guidance on the nature of the auditors' considerations is given in the section of this Practice Note dealing with SAS 120 and specific circumstances requiring a report to the Charity Commission is given in the section of this Practice Note covering SAS 620.

### ***Features of engagement letters for charities***

94. Appendix 3 gives a specimen engagement letter for the audit of an unincorporated charity based on the example in SAS 140, followed by alternative paragraphs which might be used in different circumstances. The examples are based on the charities legislation summarised in Appendix 1. Separate engagement letters will be obtained for non-audit work undertaken on behalf of the charity or its trustees.

## SAS 160: OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

### **Background note**

*The SAS requires that auditors should read the other information in documents containing audited financial statements. If, as a result, the auditors become aware of any apparent misstatements therein, or identify any material inconsistencies with the audited financial statements, they should seek to resolve them.*

95. One of the fundamental principles set out in The Auditors' Code is that auditors do not allow their reports to be included in documents containing other information if they consider that the additional information is in conflict with the matters covered by their report and they have cause to believe it to be misleading.

96. Other information is usually disclosed as part of the Trustees' Annual Report, but may be contained in other parts of a document containing the audited financial statements. Auditors check such information to ensure that there are no inconsistencies which could either confuse readers of the accounts, or cast doubt on the reliability of the audited information. Examples include:

- 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;
- a risk management statement by trustees (based on the Charities SORP or expanded and based on the Combined Code for listed companies or the Turnbull Report);
- a treasurer's report;
- financial summaries; and
- projections of future expenditure based on planned activity.

Additional care will be needed where, for example, the annual report and the financial statements are prepared at the same time but by different personnel, so that their content is largely independent.

97. The Charities SORP requires charity trustees to state in their report that the major identified risks to which the charity is exposed have been reviewed and that systems have been established to mitigate such risks. Whilst in England and Wales the Regulations (E&W) do not require such disclosure for charities with gross income not exceeding £250000, it is good practice for the trustees to make a statement about risk assessment and mitigation. SAS160.1 requires auditors who become aware of any apparent misstatements or inconsistencies in other information published together with the audited financial statements to seek to resolve them. Whilst auditors are not expected to verify any risk management statement made by trustees they are likely to become aware of the steps taken by the trustees to identify and mitigate identified financial risks through their work in assessing audit risk under SAS 300. They may also become aware of non-financial risks during the course of their audit. If, after discussion with the trustees, any significant misstatement or apparent inconsistency identified by auditors in relation to a corporate governance or risk management statement remains in a Trustees' Report, the auditors consider reporting this in the opinion section of their report. It should be noted that, as this does not give rise to a qualified audit opinion on the financial statements, the auditors' comments may be included under the heading 'other matter' as illustrated in the APB Bulletin 1999/5.

98. Charity trustees may request auditors specifically to review 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.

# PLANNING CONTROLLING AND RECORDING

## SAS 200 : PLANNING

### Background note

*The SAS requires that auditors should plan the audit work so as to perform the audit in an effective manner. The auditors should develop and document an overall audit plan describing the expected scope and conduct of the audit and the nature, timing and extent of planned audit procedures required to implement the overall plan. The audit work planned should be reviewed and, if necessary, revised during the course of the audit.*

99. Particular issues auditors consider, at the planning stage, include:

- the charity's activities in the context of its stated objects and powers. Particular issues include any limitations in objectives placed on the charity by its governing document, or terms and restrictions placed on material gifts or donations received,
- the extent to which the charity's activities (either of a fundraising or a charitable nature) are undertaken through branches or overseas activities and the impact this has on the auditors' required knowledge of the business (for example taxation and employment law), their risk assessments and sources of audit evidence,
- the likely impact on the financial statements of the charity of the activities of any connected entities (for example, a separate limited company set up to undertake commercial activities for the charity),
- the structure and management of any connected entities, in particular the degree to which connected entities are managed and controlled by the trustees and management of the charity. Where the charity is not a company and/or where the connected entity is not a subsidiary<sup>16</sup>, auditors of the connected entity normally owe duties of confidentiality to that entity. In these cases the charity's auditors will ordinarily wish to put arrangements in place through the trustees of the charity and directors of the connected entity to allow the connected entity, and its auditors, to give the auditors of the charity such information and explanations as they may reasonably require for the purposes of their duties as auditors of the charity. The charity's auditors also consider discussing their particular responsibilities under the 1993 Act and the Regulations with the auditors of the connected entity, so that these are fully understood, and
- whether other auditors' reports are required– for example special reports to funders of the charity, grant donors or EU agencies.

<sup>16</sup> In these instances the provisions of section 389A(3) of the Companies Act 1985 (concerning the reporting responsibilities of auditors of subsidiary companies) do not apply.

## SAS 210: KNOWLEDGE OF THE BUSINESS

### **Background note**

*The SAS requires that auditors should have or obtain a knowledge of the business to be audited which is sufficient to enable them to identify and understand the events, transactions and practices that may have a significant effect on the financial statements and the audit thereof.*

*The SAS also requires that the audit engagement partner should ensure that the audit team obtain such knowledge of the business of the entity being audited as may reasonably be expected to be sufficient to enable it to carry out the audit work effectively.*

100. The principles of acquiring and using knowledge of the charity to be audited are the same as those applying to the audit of any entity. Auditors' responsibilities in this respect are not related to the level of fee which they charge for their audit work: for example, the same knowledge and understanding of the client charity are required in respect of audits carried out on an honorary basis as for audits carried out for a commercial fee.

### **The regulatory framework**

101. As explained in Appendix 1, provision for the oversight of charities in the United Kingdom is different in England and Wales, Scotland and Northern Ireland and the auditors need to ascertain and understand the applicable law 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 client charity in particular.

102. A key element in this part of the audit process is a knowledge and understanding of the charity's governing document. As explained in paragraphs 11 to 14 of the Introduction, 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.

### **Special features of charities**

103. Knowledge of the charity's activities and organisation is essential for ascertaining the risk of material misstatement arising from fraud, error, or non-compliance with applicable law and regulations. The special features of charities described in the Introduction, (ie the nature and sources of income, restricted funds, trading and charitable status, taxation and operating structures and branches), are considered by the auditors in order to plan and carry out audit work effectively and efficiently, and to provide a yardstick against which to evaluate the evidence gained from audit tests.

104. Sources of income often include grants, for example from public authorities or other charities. Such grants are often made for specific purposes and are subject to conditions,

breach of which can have serious implications for the charity. Developments in the public sector mean that auditors of a public authority donor may have, or seek, the right of access to the charity's records to follow through and verify the use made of the grant. In addition grants from public bodies are often, and increasingly, subject to clawback provisions requiring repayment if a charity breaches specified conditions.

105. Where charities receive funding to undertake operational activities, auditors ascertain whether such income is received under contract (which is generally unrestricted income) or by way of grant for provision of a specific service (which normally gives rise to restricted income). As well as impacting whether the income is restricted or not, the nature of the terms and conditions may affect taxation considerations (eg the VAT treatment).

106. 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 charity finance directors' groups. Available statistics include responses to mailshots (i.e. donations received), and industry norms such as sales per square foot for trading operations in different areas.

107. The trustees of smaller charities may not have formal documentation of their activities which can be used to chart the charities' progress through the year, although auditors may be able to encourage trustees to keep such records. The most useful source of information in these circumstances is likely to be discussion with the trustees.

### **Branches**

108. Auditors need a clear understanding of the legal structure of a charity. A charity may operate through branches to raise funds or carry out particular aspects of its charitable activities. Auditors need to understand whether the structure adopted by a charity falls within the Charities SORP definition of a branch. This definition is set out in Appendix 1 of the Charities SORP and is summarised in Appendix 9 of this Practice Note. The principles set out in the Charities SORP apply whether operations are carried out in the UK or overseas.

109. Branches which fall within the Charities SORP definition will be accounted for as part of the whole charity. Therefore the omission of branches where material will affect the audit opinion. Auditors also need to be aware that some charities will use the term "branches" outside of its 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.

110. Joint venture situations whereby two or more charities jointly control an entity or undertake joint arrangements in partnership to carry out an activity are sometimes applicable. Auditors need to understand the structure adopted in such arrangements and how they are differentiated from participating interests in associates. The Charities SORP provides guidance on this issue and the accounting methods to be adopted.

111. Auditors will also need to consider the terms on which branches raise funds. 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.

112. Further guidance on the considerations necessary where branches exist is set out in relation to audit risk and internal controls (SAS 300), recognition of income (SAS 400) and reliance on other auditors (SAS 510).

### ***Non-departmental public bodies***

113. A number of non-departmental public bodies are charities. The auditors of such bodies are responsible for expressing an opinion on both the view given by the body's financial statements<sup>17</sup> and on whether the expenditure of the body is in accordance with the purposes intended by Parliament. In addition, the Treasury requires sponsor departments of such bodies to include, in the terms of engagement for the auditors of a non-departmental public body appointed by the Secretary of State of the sponsor department, a responsibility to report to the department any significant matters arising out of their audit work, including losses incurred owing to failures of internal control, misconduct, fraud or other irregularity.

114. Practice Note 10 'Audit of financial statements of public sector entities in the United Kingdom' provides guidance for auditors of public bodies on the form of reports required and factors to be taken into account in the conduct of their work.

### ***Overseas operations***

115. The considerations noted above apply equally where activities are carried out overseas. Auditors take into account the fact that significant aspects of a charity's business may be conducted in conditions or parts of the world which are not readily accessible. In these circumstances the auditors will need to ensure that they are 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 – for example in relation to taxation and employment law. Further guidance on the considerations necessary where a charity undertakes overseas activities is set out in the section of this Practice Note on audit evidence (SAS 400).

## **SAS 220: MATERIALITY AND THE AUDIT**

### **Background note**

*The SAS requires that auditors should consider materiality and its relationship with audit risk when conducting an audit. Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects. Auditors are required to consider materiality when determining the nature, timing and extent of audit procedures and should assess the materiality of the aggregate of uncorrected misstatements when evaluating whether the financial statements give a true and fair view.*

17 These financial statements should comply with Treasury guidance (Executive Non-Departmental Public Bodies: Annual Reports and Accounts Guidance) to the extent that the guidance does not conflict with the charities SORP.

### **Materiality and audit work**

116. SAS 220 makes a distinction between the auditors' consideration of materiality in planning the audit, and that at the time of evaluating the results of audit procedures. The assessment of materiality at the planning stage influences the nature, timing and extent of audit tests. The materiality of matters found in the course of audit work is considered both in relation to their possible impact on the financial statements, and in relation to applicable regulations and other factors governing the conduct of individual charities. In the case of charities particular disclosures or expenditure categories may be sensitive and warrant extra attention, for example remuneration, restricted funds and costs of generating funds. If the auditors are engaged to make additional reports, for example in respect of restricted grants, it will be appropriate for the auditors to make a separate assessment of materiality specifically for the purposes of such additional engagements.

### **Planning**

117. The auditors clarify with management which entities will form part of any consolidated 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 auditors consider 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, for example;
- consideration of prior year figures; and
- any budgeted or preliminary results;

and incorporate the resulting best estimate into the materiality calculation for the audit as a whole. Further guidance on consolidated financial statements is given in paragraphs 189-191 below.

### **Restricted funds**

118. Many charities may receive funds which are 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. It is not necessary in every case to set a different monetary materiality level for such funds: however, SAS 220 indicates that materiality may be influenced by considerations such as legal and regulatory requirements, which may result in different materiality considerations being applied to particular aspects of the financial statements<sup>18</sup>. Auditors therefore consider whether this is appropriate when planning the nature and extent of their work in relation to restricted funds. Any breaches of the terms of

trusts relating to restricted funds which come to the auditors' attention in the course of their work, regardless of materiality to the financial statements as a whole, need to be considered in terms of their significance to the auditors' report on the financial statements and brought to the attention of trustees, as a failure on their part to comply with the terms of trusts may place them in breach of their responsibilities.

### ***Evaluation of results***

119. Paragraph 3 of SAS 220 explains that materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects. The auditors consider materiality in assessing whether the accounts give a true and fair view from the point of view of the addressees of the report (in most cases, the trustees). The principles underlying this consideration of materiality are no different from those involved in the audit of other entities and are explained in SAS 220. In forming their opinion as to whether the financial statements of a charity show a true and fair view, auditors do not have a duty to consider materiality in relation to the possible expectations of secondary stakeholders such as regulators or other third parties.

120. The auditors of unincorporated charities in England and Wales (unless an exempt charity) have a duty under the Regulations (E&W)<sup>19</sup> to report matters described as 'of material significance' for the exercise, in relation to the charity, of the Charity Commission's powers to institute enquiries or to act for the protection of charities. 'Material significance' in this context is different from materiality for the purposes of reporting on financial statements; circumstances in which a duty to report may arise are considered in more detail in the section on SAS 620, dealing with the auditors' duty to report to regulators.

## **SAS 240: QUALITY CONTROL FOR AUDIT WORK**

### **Background note**

*SAS 240 requires that firms should establish and communicate quality control policy and processes; this involves the establishment of an appropriate structure within the firm and the appointment of a senior audit partner to take responsibility for these matters.*

*The SAS requires that, before accepting a new audit engagement, firms should ensure that they are competent to undertake the work and will be able to safeguard their objectivity and independence, that they assess the integrity of owners, managers and directors, and that they comply with ethical requirements in relation to changes in appointment. Firms should also ensure that they consider these matters, before the end of their term of office, when deciding whether they are willing to continue in office as auditor.*

<sup>19</sup> The 1995 Regulations (E&W) mean the Charities (Accounts and Reports) Regulations 1995; the 2000 Regulations (E&W) mean the Charities (Accounts and Reports) Regulations 2000 – collectively they are referred to as the Regulations (E&W).

*The SAS requires that firms should have sufficient audit partners and audit staff with the relevant competencies to meet their needs. An audit engagement partner should be appointed to each audit engagement undertaken by a firm, to take responsibility for the engagement on behalf of the firm. Firms should assign audit staff with the competencies needed to perform the audit work to individual audit engagements. Firms should establish procedures, and have sufficient resources, to facilitate consultation in relation to difficult or contentious matters; the results of consultation that are relevant to audit conclusions should be documented.*

*The SAS requires that audit engagement partners should, in all cases, take responsibility on behalf of the audit firm for the quality of the audit engagements to which they are assigned. Audit engagement partners should consider whether adequate arrangements are in place to safeguard their objectivity and the firm's independence, and document their conclusions. They should ensure that audit work is directed, supervised and reviewed in a manner that provides reasonable assurance that the work has been performed competently.*

*The SAS requires that firms should ensure that an independent review is undertaken for all audit engagements where the audited entity is a listed company. In addition, firms should establish policies setting out the circumstances in which an independent review should be performed for other audit engagements, whether on the grounds of the public interest or audit risk. The independent review should take place before the issue of the auditors' report and provide an objective, independent assessment of the quality of the audit performed; firms' policies should set out in detail the manner in which this objective is to be achieved. The SAS requires that firms should establish procedures for dealing with any conflicting views between those involved in the audit regarding important matters.*

*The SAS requires that firms should appoint a senior audit partner or a suitably qualified external consultant to take responsibility for monitoring the quality of audits carried out by the firm.*

121. This section provides auditors with supplementary guidance on:

- the assessment of their competence to undertake charity audit engagements; and
- factors to be taken account of in determining when an independent review of an audit of a charity may be appropriate.

### **The assessment of competence to undertake audit engagements**

122. Before commencing the audit of a charity a firm ensures that it has enough staff who have adequate knowledge and experience of such audits. All staff involved in a charity audit should have a broad understanding of:

- the general principles of the Charities SORP ( paragraphs 33 to 55);
- the objects of the charity as set out in the governing document of the particular charity;
- an overview of the legal responsibilities and duties of charity trustees as set out in paragraphs 44 to 47 of Appendix 1;
- the standards and guidance in SAS 620, and in the SAS 620 section and Appendix 8 of this Practice Note.

123. Further understanding, commensurate with the individual's role and responsibilities in the audit process, is required of:

- The Charities SORP;
- the governing document of the charity;
- the legal and regulatory framework in which charities and their trustees operate sufficient to meet the requirements of Auditing Standards and to apply the guidance set out in this Practice Note.

**Factors to be taken account of in determining when an independent review of an audit of a charity may be appropriate**

124. The SAS requires that firms should establish policies setting out the circumstances in which an independent review should be performed for other audit engagements, whether on the grounds of the public interest or risk.

125. When establishing their policy in relation to charities firms will wish to consider the size and characteristics of the charities they audit. Generally independent reviews are more likely to be appropriate to larger, more complex, entities than smaller ones, and to higher profile entities than lower profile entities. But this will not necessarily be the case, and an independent review may be appropriate for smaller entities, for example if there is a particularly high level of public or media interest in the entity.

# ACCOUNTING SYSTEMS AND INTERNAL CONTROL

## SAS 300: ACCOUNTING AND INTERNAL CONTROL SYSTEMS AND AUDIT RISK ASSESSMENTS

### **Background note**

*The SAS requires that auditors should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The SAS also requires that auditors should use their professional judgment to assess the components of audit risk and to design audit procedures which ensure that it is reduced to an acceptably low level.*

*The SAS requires that, in developing their audit approach and detailed audit procedures, auditors should assess inherent risk in relation to financial statement assertions about material account balances and classes of transactions, taking account of factors relevant both to the entity as a whole and to the specific assertions. The SAS requires that, in planning the audit, the auditors should obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach.*

*The SAS requires that auditors should consider the assessed levels of inherent and control risk in determining the nature, timing and extent of their substantive procedures required to reduce audit risk to an acceptable level. Regardless of the assessed levels of inherent and control risks, auditors should perform some substantive procedures for financial statement assertions of material account balances and transaction classes.*

### **General**

126. An internal control system comprises the control environment and control procedures established by management to assist in achieving the objective of ensuring, as far as practicable, the orderly and efficient conduct of the business. This includes adherence to internal policies, safeguarding assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. As noted in paragraph 8 of SAS 300, the internal control system extends beyond those matters which relate directly to the accounting system.

127. 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. A guidance leaflet entitled 'Internal financial controls for charities' has been published by the Charity Commission, and this provides a useful point of reference for auditors.

### ***The regulatory framework***

128. Certain charities, for example registered friendly societies<sup>20</sup>, are subject to specific reporting requirements in respect of internal controls. Where there is such a requirement, the auditors plan their work bearing in mind the need to report if a satisfactory system of control over transactions has not been maintained.

### ***The operations of charities***

129. There is a very wide variation between different charities in terms of size, activity and organisation, so that there can be no 'standard' approach to internal control systems and audit risk assessments. Charities undertake a variety of activities, through varying structures that may include both UK and overseas branches that will present widely different control risks. Internal control systems will be developed in relation to the specific risks associated with income sources, the activities undertaken, and location and staffing arrangements.

130. Aspects of the control environment and inherent risks and control procedures which are special to charities are described below. Control procedures which are not specific to charities, such as segregation of duties or physical security of tangible assets are not included in the examples but are equally relevant to the auditors' assessment of the components of audit risk.

131. Where the system of controls appears to be weak or where breaches of internal rules or procedures have occurred and not been corrected, and these matters have come to the attention of the auditors, the auditors consider the implications for their reporting responsibilities. The sections on SASs 600, 610 and 620 give guidance on the points that the auditors might consider in relation to reports to trustees, management, and external authorities respectively.

### ***Inherent risk***

132. Special features of charities which are particularly relevant in the planning and conduct of audit work are described in the Introduction. Factors which may affect the assessment of inherent risk include:

- the complexity and extent of regulation;
- the significance of donations and cash receipts;
- the extent of donations over the internet or by credit card;
- the valuation of donations in kind;
- difficulties of the charity in establishing ownership and timing of voluntary income where funds are raised by non-controlled bodies;

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<sup>20</sup> The requirements, applicable to friendly societies, of the Industrial and Provident Societies Act regarding internal control are dealt with in Practice Note 14 The audit of registered social landlords in the United Kingdom.

- lack of predictable income or precisely identifiable relationship between expenditure and income which makes it difficult for the charity to ensure that income to which it is entitled is actually received;
- uncertainty of future income which can make consideration of future operations and viability of the charity difficult;
- the objects and powers given by charities' governing documents are often narrower than in the equivalent documents for commercial entities. Failure to act in accordance with those objects and powers is more likely to have consequences for the financial statements, and therefore the auditors' report, than a transaction by a commercial company which is not permitted by its Memorandum or Articles of Association;
- restricted funds held by many charities which require special considerations as to use and accounting;
- the extent and nature of trading activities must be compatible with the entity's charitable status;
- the complexity of tax rules (whether Income, Capital, Value Added or local rates) relating to charities;
- difficulties in identification and quantification of liabilities arising from constructive obligations<sup>21</sup>;
- the sensitivity of certain key statistics, such as the proportion of resources used in administration and fund-raising; and
- the need to maintain adequate resources for future expenditure while avoiding the build up of reserves which could appear excessive to potential donors or be incompatible with the entity's charitable status.

### **Control risk**

133. The role, attitude and actions of the trustees are fundamental in shaping the control environment of a charity. Factors to consider include:

- the amount of time committed by trustees to the charity's affairs;
- the skills and qualifications of individual trustees;
- the frequency and regularity of trustee meetings;
- the form and content of trustee meetings;
- the independence of trustees from each other;
- the division of duties between trustees;
- the supervision by the trustees of relatively informal working arrangements which are

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21 See also paragraph 123 of the Charities SORP.

common when employing volunteers; and

- the degree of involvement in, or supervision of, the charity's transactions on the part of individual trustees.

134. Other features of the control environment will depend on the size, activities, organisation and corporate governance structures of the charity but might include:

- a recognised plan of the charity's structure showing clearly the areas of responsibility and lines of authority and reporting. Where the charity does not have staff, and is administered entirely by the trustees, there can still be an agreed division of duties, provided there is adequate monitoring by the body of trustees as a whole;
- segregation of duties where charities have more than one member of staff (whether paid or not). In larger charities, such segregation could include involvement of staff from outside the finance department in certain transactions, for example in providing a first signatory for cheques;
- supervision by trustees of activities of staff where segregation of duties is not practical;
- competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform;
- involvement of the trustees in the recruitment, appointment and supervision of senior executives;
- access of trustees to independent professional advice where necessary;
- budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis; and
- communication of results of such reviews to the trustees on a regular basis so as to facilitate their review of performance and enable them to initiate action where necessary.

### ***Control procedures***

135. The following tables set out some of the control procedures which are special to charities. A particular difficulty for charity trustees in establishing control procedures can stem from the use of volunteers (often on a part-time basis) who are not formally accountable to them, unlike employees. Nevertheless, it is important for charities raising a significant proportion of income through street collections undertaken by volunteers to ensure that collectors are adequately supervised and controlled. The tables are not intended to be comprehensive: there may be other control procedures which will be relevant to a particular charity's activities and control procedures which are of general application (such as segregation of duties or physical security of tangible assets) which are not included in the examples given below. The nature and extent of the procedures will clearly depend on the size of the charity.

**Table 1: cash donations**

| <i>Source</i>              | <i>Examples of controls</i>   |
|----------------------------|---|
| Collecting boxes and tins  | numerical control over boxes and tins<br>satisfactory sealing of boxes and tins so that any opening prior to recording cash is apparent<br>regular collection and recording of proceeds from collecting boxes<br>dual control over counting and recording of proceeds |
| Other cash receipts        | clear directions to staff on how to handle cash donations<br>advice to donors on where to make donations securely   |
| Postal receipts            | unopened mail kept securely<br>dual control over the opening of mail<br>immediate recording of donations on opening of mail or receipt<br>agreement of bank paying-in slips to record of receipts by an independent person  |
| Receipts over the internet | sending a confirmation of receipt to the donor<br>controls over the writing up of daybooks  |

**Table 2: other donations**

| <i>Source</i>              | <i>Examples of controls</i>  |
|----------------------------|--|
| Gift aid/Deeds of covenant | regular checks and follow-up procedures to ensure due amounts are received<br>regular checks to ensure all tax repayments have been obtained   |
| Legacies                   | comprehensive correspondence files maintained in respect of each legacy, numerically controlled<br>searches of agency reports of legacies receivable<br>regular reports and follow-up procedures undertaken in respect of outstanding legacies<br>security of chattels received as legacies and procedures to establish their value and proper realisation |

|                   |  |
|-------------------|--|
| Donations in kind | in case of charity shops, separation of recording, storage and sale of stock<br>all types of activity: immediate recording of donated assets |
|-------------------|--|

**Table 3: other income**

| <i>Source</i>                                 | <i>Examples of controls</i>  |
|---|--|
| Fund-raising activities                       | records maintained for each fund-raising event<br>other controls maintained over receipts appropriate to the type of activity and receipt (as set out in tables 1 and 2)<br>controls maintained over expenses as for administrative expenses   |
| Central and local government grants and loans | regular checks that all sources of income or funds are fully utilised and appropriate claims made ensuring income or funds are correctly applied in accordance with the terms of the grant or loan<br>comprehensive records of applications made and follow-up procedures for those not discharged |

**Table 4: fixed assets**

| <i>Source</i>       | <i>Examples of controls</i>  |
|---------------------|--|
| Existence of assets | a register of fixed assets maintained, including donated assets  |
| Valuation           | donated assets recorded at approximate market value, where appropriate<br>depreciation calculated and recorded in accordance with proper assessment of future benefits deriving from assets' use |

**Table 5: use of funds**

| <i>Resource</i>         | <i>Examples of controls</i>  |
|-------------------------|--|
| Restricted funds        | separate records maintained of relevant revenue, expenditure and assets terms controlling application of funds<br>oversight of application of fund moneys by independent personnel or trustees   |
| Grants to beneficiaries | records maintained, as appropriate, of requests for material grants received and their treatment<br>appropriate checks made on applications and applicants for grants, and that amounts paid are intra vires<br>records maintained of all grant decisions, checking that proper authority exists, that adequate documentation is presented to decision-making meetings, and that any conflicts of interest are recorded<br>controls to ensure grants made are properly spent by the recipient for the specified purpose, for example requirements for returns with supporting documentation or auditors' reports concerning expenditure, or monitoring visits. |

***Branch operations***

136. Many charities carry out their operations through branches based either in the United Kingdom or overseas. Set out below are the control procedures that the charity may implement:

- regular reports or returns to the charity's head office by any branch, office or individual representative of the charity, checks to ensure that all these are received, and a mechanism for monitoring branch activities, for example by comparison of expenditure to budget;
- prompt investigation of any report of the misuse of the charity's name;
- internal controls of equivalent standard to those of the main charity in any branch where the trustees of the charity have direct control;
- existence of an accounts manual and the standardisation of procedures at all branches;
- proper acknowledgements of remittances to and from abroad;

- clarity of instructions and guidelines as to receipt and transfer of income to identify the point at which it belongs to the main charity;
- controls over recruitment and appointment of staff to run branch operations;
- defined authorisation limits and responsibilities for local staff in ordering and paying for goods and services;
- if the amounts involved are material, periodic checks by internal audit or head office personnel;
- retention of documents for local inspection (for example at overseas locations if local law requires this) or for periodic transmission to the head office; and
- in the case of overseas branches, controls over treasury operations, for example to ensure that unspent cash balances are held in hard currencies and in secure holdings where the overseas economy is inflationary and conditions are unstable.

# EVIDENCE

## SAS 400: AUDIT EVIDENCE

### **Background note**

*The SAS requires that auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their audit opinion. The SAS also requires that, in seeking to obtain audit evidence from substantive procedures, auditors should consider the extent to which that evidence together with any evidence from tests of controls supports the relevant financial statement assertions.*

137. The requirement to obtain sufficient appropriate audit evidence applies to the audit of charities as to the audit of any other entity carried out in accordance with Auditing Standards. The purpose of this section of the Practice Note is to provide additional guidance to auditors on the special characteristics of charities which may affect the nature of audit evidence, in particular in relation to the completeness of income.

### **Sources and completeness of incoming resources**

138. The incoming resources of charities often involve a number of different sources, ranging from grants from government departments to occasional cash donations by members of the public in response to street collections. Whilst it is the trustees' responsibility to safeguard the assets and incoming resources of the charity, the voluntary nature of some elements of its incoming resources raises considerations concerning the methods available to the trustees for the purposes of ensuring that all incoming resources to which the charity is entitled are correctly accounted for. These considerations differ from those in commercial concerns: the amount of voluntary donations cannot in many cases be determined in advance, nor can a charity be regarded as necessarily entitled to funds, even when the amounts can be predicted, before they are donated to it. 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.

139. The Charities SORP reflects this position. Discussing the criteria for recognising incoming resources, it states

“ The value of all resources-both for income and endowment funds-accruing to the charity should be recorded in the Statement of Financial Activities as soon as it is prudent and practicable to do so. In all cases incoming resources should not be recognised until the conditions for receipt have been met and there is reasonable assurance of receipt. This will be dependent on the following three factors being met:

- (a) entitlement-normally arises when a particular resource is receivable or the charity's right to it becomes legally enforceable;
- (b) certainty-when there is reasonable certainty that the incoming resource will be received; and
- (c) measurement-when the monetary value of the incoming resource can be measured with sufficient reliability. "

140. When considering whether donations and gifts receivable by a charity are properly recorded, therefore, auditors seek evidence to determine whether the accounting records reflect cash and other forms of donation from the point at which the charity is entitled to them. Where the auditors are satisfied, through evaluation and testing, that there are appropriate and effective controls, they can use the results of their internal control testing as a source of audit evidence about the completeness of recorded transactions. Examples of control procedures which can be established by trustees are given in the section on SAS 300.

141. Analytical procedures may also be used as a source of audit evidence about the completeness of incoming resources. Whilst the degree of inherent uncertainty affecting donated incoming resources may restrict the reliance which can be placed on such techniques in respect of donations, they nevertheless provide a source of additional corroborative evidence to supplement that drawn from the auditors' consideration of relevant controls over completeness of incoming resources from donations. Auditors therefore undertake analytical procedures to assess whether such incoming resources are consistent with their knowledge of the charity and its activities over the period, and consider undertaking other forms of analytical review. Guidance on analytical procedures in respect of charities is included in the paragraphs on SAS 410 below.

142. The combination of testing of and reliance on internal controls and, where appropriate, analytical review procedures and substantive testing of accounting records normally provide the auditors with sufficient, appropriate evidence on which they can determine whether the incoming resources included in a charity's financial statements is, in all material respects, complete. If the auditors are unable to obtain satisfactory evidence in any material respect, they consider the implications for their report in accordance with the principles set out in SAS 600. They also consider whether the limitation on the scope of their work results from factors which should be reported to management under SAS 610, and possibly to the proper authority under SAS 620.

143. Factors to be considered when assessing completeness of incoming resources in particular instances commonly include the following:

- *loss of incoming resources through fraud:* auditors consider the possibility that the charity's records of incoming resources 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 to bank or building society accounts which they do not control. Sources of

audit evidence as to whether incoming resources from appeals and other 'non-routine' sources have been fully recorded can involve the assessment and testing of the sort of internal controls described in the section on SAS 300, and comparison of donations actually received by the charity to past results for similar appeals and statistics for response rates for charities in general;

- *recognition of incoming resources from professional fund-raisers*: income recognition can be a complex issue where a charity obtains resources by means of fund-raising organisations<sup>22</sup>. The agreement (between the charity and the fund raiser) and other documents relating to the transaction can be checked by auditors to see whether all donations received in the charity's name have been transmitted to it or otherwise accounted for;
- *recognition of incoming resources from branches, associates or subsidiaries*: if charities use branches, associates or subsidiaries to raise funds, auditors can check the arrangements made by the main charity to determine at what point incoming resources are recognised;
- *informal fund-raising groups*: where informal fund-raising groups raise money or other resources for charitable purposes on a voluntary basis, without 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 auditors have 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, since its ultimate cash realisation, so far as the charity itself is concerned, cannot be determined with sufficient certainty;
- *grants receivable*: in the case of grant funded charities, an examination of the grant applications and correspondence is a useful way of verifying completeness of incoming resources. It may also be possible to obtain direct confirmation of the amounts receivable from the grant provider; and
- *Non-cash donations*: satisfactory operation of internal controls may enable the auditors to obtain sufficient appropriate audit evidence as to the recognition and measurement of donations made by way of goods, other assets or services. The trustees of a charity should develop procedures for recording donations in kind and ensure that the policy for valuing the assets or services received is consistent with the Charities SORP. The basis of any valuation of non-cash donations should be clearly stated in the notes to the financial statements and consistently applied. The auditors consider whether the policy is reasonable in the circumstances and has been properly applied.

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22 The Charities Act 1992, Section 59 requires there to be an agreement between the charity and the fund raiser in a prescribed form.

### ***Overseas operations***

144. Overseas operations can take a number of forms including branches, joint ventures with other charities, projects managed by local agents or partners through to the grant funding of autonomous local organisations.

145. Where the overseas operations form part of the charity, audit evidence will be required to support material expenditure of money in the field. An understanding of the structure of the charity will also be needed in determining at what point expenditure is incurred. 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.

146. Procedures may include:

- consideration of internal control procedures put in place by the charity, and how adherence to procedures is monitored;
- obtaining 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;
- consideration of any inspection or internal control visit reports undertaken by any internal audit function (see SAS 500 – Considering the work of internal audit); and
- consideration of audit work undertaken by local auditors (see SAS 510 - The relationship between principal auditors and other auditors).

147. Where material assets are held or material funds are applied by overseas branches or subsidiaries auditors 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.

148. Where a charity makes a significant grant to an overseas organisation that is autonomous from the charity, the auditors seek evidence to support:

- receipt of funding by that organisation; and
- that the charity has exercised reasonable diligence in ensuring application of the funds for charitable purposes (see ICTA 1988 s506(3)).

Appropriate procedures may involve the vetting of applications, reviewing project reports received, setting thresholds for site visits to projects involving significant grant funding, reviewing accounts and the local certification of expenditure.

## SAS 410: ANALYTICAL PROCEDURES

### **Background note**

*The SAS requires auditors to apply analytical procedures at the planning and overall review stages of the audit.*

*The SAS requires that when significant fluctuations or unexpected relationships are identified that are inconsistent with other relevant information or that deviate from predicted patterns, auditors should investigate and obtain adequate explanations and appropriate corroborative evidence.*

149. A particular difficulty in applying analytical procedures to the audit of charities is that certain items in the financial statements can be very difficult to predict. The usefulness of individual procedures depends on the scale and nature of activities undertaken, but examples of measures that can be adopted include:

- comparison of actual income and expenditure to prior years' figures and trends;
- comparison of actual to budgeted results;
- comparison of actual expenditure to the auditors' own estimate of the expenditure that would be reasonable for the particular transaction under review;
- comparison of results of an individual branch to those of similar branches of the main charity;
- checking charity shops' sales revenue to a notional revenue based on the estimated sales value of stock sold;
- comparison of sales per square foot of selling space to retail sales statistics for similar shops;
- analysis of efficiency ratios such as staff or administration costs as a percentage of benefits delivered or grants made, or the ratio of operating costs to income (in this respect, care needs to be taken to compare the results of charities of similar sizes, since larger charities tend to benefit from economies of scale); and
- comparison of actual cash donations received as a result of fund-raising activities to the amount which could be expected on the basis of charity statistics, if any are available. It is likely to be helpful to analyse voluntary income into its different sources and then design analytical techniques appropriate to each source. For example, funds can be raised through television or radio appeals, street collections, trading activities, special events, telephone canvassing and postal appeals. The income raised through special events may be predicted and controlled through budgeting, whereas industry statistics and the charity's own past experience may provide a useful indication of the amount likely to be raised from a postal appeal.

## SAS 420: AUDIT OF ACCOUNTING ESTIMATES

### **Background note**

*The SAS requires that auditors should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and, when required, is appropriately disclosed.*

*The SAS requires that auditors should adopt one or a combination of the following approaches in the audit of an accounting estimate :*

- *review and test the process used by management to develop the estimate;*
- *use an independent estimate for comparison with that prepared by management or the directors; or*
- *review subsequent events.*

*The SAS requires that auditors should make a final assessment of the reasonableness of an accounting estimate based on their knowledge of the business and whether the estimate is consistent with other evidence obtained during the audit.*

150. 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 statement of financial activities. Auditors will seek to ensure that techniques selected by trustees enable the financial statements to give a true and fair view. Auditors will ensure that the financial statements disclose a description of those estimation techniques adopted, including underlying principles, that are significant in order to comply with FRS 18 'Accounting Policies' and the Charities SORP.

151. Evidence to support accounting estimates may frequently be obtained as part of the auditors' review of the post balance sheet period, for example by checking the subsequent expenditure of designated funds, or realisable value of stock. Evidence relating to cost allocations across the cost categories of the Statement of Financial Activities (SoFA) may on occasions 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, auditors consider the requirements of FRS 18 – Accounting Policies, that the accounting policies adequately explain the estimation techniques adopted.

152. 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 (for example, 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 auditors use their knowledge of the charity's activities and accounting policies to assess whether the periods for write-down of fixed assets are reasonable.

153. On occasions evidence obtained from post balance sheet review and observation may be insufficiently conclusive. Such items 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;
- valuation of inalienable and historic 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;
- recoverability of loans made to beneficiaries in the furtherance of a charity's objects.

Where such amounts are likely to be material auditors will pay particular attention to the adequacy of disclosure of the technique and bases used in their estimation. The auditors will review the process by which the estimate is arrived at and consider the basis of the calculation in terms of its reasonableness, justifiability and consistency. Auditors will draw heavily on their knowledge of the charity in testing the consistency of principles adopted. Auditors may obtain some assurance by comparison of property valuation estimates with other valuations obtained albeit for other purposes. In some cases, it may be necessary to obtain expert valuations of particular assets. Where this is the case, the requirements of SAS 520 Using the work of an expert apply.

## **SAS 440: MANAGEMENT REPRESENTATIONS**

### **Background note**

*The SAS requires that auditors should obtain written confirmation of appropriate representations from management before their report is issued. In particular, auditors should obtain evidence that the directors acknowledge their collective responsibility for the preparation of the financial statements and that they have approved them. The SAS also requires that auditors should obtain written confirmation of representations from management on matters material to the financial statements, when those representations are critical to gathering sufficient audit evidence.*

154. An important principle underlying SAS 440 is that auditors do not accept the unsupported representations of trustees or senior management of the charity where these relate to a balance or transaction which is material to the financial statements.

155. The SAS requires auditors to obtain written confirmation of appropriate representations from management. Auditors are also required to obtain written confirmation of the completeness of information made available to them concerning non-compliance with relevant law and regulations and transactions with related parties<sup>23</sup>. Alternatives to a formal letter include a letter from the auditors, setting out their understanding of management's representations, duly acknowledged and confirmed in writing by management, or minutes of a meeting of trustees at which such representations are approved. Failure to obtain written confirmation of appropriate representations represents a limitation on the scope of the auditors' work, in which case the auditors consider qualifying their opinion.

156. The body of trustees of a charity as a whole is responsible for the contents and presentation of the financial statements. Consequently, discussion of the content of any written representation by the body of trustees as a whole is necessary before it is signed on behalf of the trustees, often by one of their members. In many charities day to day management may be delegated to a non-trustee chief executive and other senior managers. Where representations are taken from such senior staff auditors will ensure such staff have the necessary authority and that such representations are considered and approved by the trustees. In larger charities approval may come from a finance or audit committee properly authorised by the trustees and including trustee members with a reporting line back to the main trustee body.

157. Communication with the trustees on significant issues on which representations are required remains of particular relevance in a sector which relies primarily on voluntary trustees.

158. An example of a representation letter is given in Appendix 4. Only where there is a separate, formal acknowledgement by the trustees of their responsibility for the annual financial statements, and there are no other matters, such as accounting estimates and judgments which are material to the financial statements, do auditors consider a representation letter to be unnecessary.

## **SAS 450: OPENING BALANCES AND COMPARATIVES**

### **Background note**

*The SAS requires that auditors obtain sufficient appropriate audit evidence that amounts derived from the preceding period's financial statements are free from material misstatements and are appropriately incorporated in the financial statements for the current period.*

159. Special considerations will apply where an unincorporated charity either 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 or reporting accountant.

160. In the former case, the auditors consider whether sufficient, appropriate evidence can be obtained as to the figures contained in any statement of balances or of assets and liabilities. Procedures include checking bank statements, the review of receipts and payments after the year end, and physical check of any tangible fixed assets. For analytical review purposes, the auditors may need to calculate adjustments to the figures which were prepared on a receipts and payments basis to enable them to be compared fairly with the current period's figures.

161. In the case of financial statements not previously subject to audit, the auditors consider whether they can obtain sufficient, appropriate audit evidence that opening balances have been properly brought forward and do not contain errors or misstatements that materially affect the current period's financial statements. Again, the procedures that can be adopted include the review of transactions since the previous year end, to ascertain whether they support the figures included in the previous year's financial statements. Auditors consider whether, by performing additional procedures, they can place reliance on, or reconstruct, figures for the preceding period.

162. If the auditors are unable to obtain sufficient appropriate audit evidence, they consider the implications for their report.

## **SAS 460: RELATED PARTIES**

### **Background note**

*The SAS requires that auditors should plan and perform the audit with the objective of obtaining sufficient audit evidence regarding the adequacy of disclosure of related party transactions and control of the entity in the financial statements. The SAS requires that, when planning the audit, the auditors should assess the risk that material undisclosed related party transactions may exist.*

*The SAS requires that the auditors should review for completeness information provided by the directors identifying material transactions with those parties that have been related parties for any part of the financial period. In addition, the SAS requires that the auditors should be alert for evidence of related party transactions that are not included in the information provided by the directors.*

*The SAS requires that the auditors should obtain sufficient appropriate audit evidence that material identified related party transactions are properly recorded and disclosed in the financial statements. The SAS also requires that the auditors should obtain sufficient audit evidence that disclosures in the financial statements relating to control of the entity are properly stated.*

*The SAS requires that auditors should obtain written representations from the directors concerning completeness of information provided regarding the related party and control disclosures in the financial statements.*

163. The principles and procedures set out in SAS 460 apply to the audit of charities as for other entities. The auditors consider the steps taken by the trustees to identify and record related party transactions and remain alert, in carrying out their audit, for evidence of such transactions which are not included in the information provided by the trustees.

164. It is a fundamental principle of trust law that a trustee should not benefit directly or indirectly from his or her trust unless explicit authority exists to do so. This means that neither charity trustees nor persons connected with them should transact business with the charity (or with any company owned by the charity), other than meeting or reimbursing properly incurred expenses, except where the transaction, and any benefit (including remuneration) derived from it, is either expressly permitted by the charity's governing document, or permission has been obtained from an appropriate authority (for example, the Charity Commission for charities based in England and Wales).

165. FRS 8 – Related Party Disclosures applies to the financial statements of charities as it does to those of other entities. Auditors, in considering related party transactions, will be aware that any decision by a charity to enter into a transaction ought to be influenced only by the consideration of the charity's own interests, and that a charity may need explicit powers to enter into a transaction that may give rise to a benefit to a trustee or person connected with such a trustee.

166. Paragraphs 157 to 165 of the Charities SORP provides examples of related party transactions and disclosures required which includes remuneration or benefits paid to trustees or persons connected with them. The Charities SORP related party disclosures are also required by paragraph 1(d) of the Schedule to Regulation 3(10) of the 2000 Regulations (E&W).

167. In England and Wales the adequacy of related party disclosures is an issue that will receive particular consideration in inquiries instituted under section 8 of the 1993 Act by the Charity Commission in relation to unauthorised trustee remuneration or benefit. Where such unauthorised remuneration or benefit is identified auditors consider the guidance provided in the SAS 620 section of this Practice Note.

## **SAS 470: OVERALL REVIEW OF FINANCIAL STATEMENTS**

### **Background note**

*The SAS requires that auditors should carry out such a review of the financial statements as is sufficient, in conjunction with the conclusions drawn from other audit evidence obtained, to give them a reasonable basis for their opinion on the financial statements.*

*The SAS requires that auditors should consider whether the information presented in the financial statements is in accordance with the statutory requirements and whether the accounting policies employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity. Auditors should also consider whether the financial statements as a whole and the assertions made therein are consistent with their knowledge of the entity's business and with the results of other audit procedures, and whether the manner of disclosure is fair.*

168. The analytical procedures described in the section on SAS 410 are used by auditors to identify trends and relationships between individual figures. In addition, most charities generate non-financial information such as fund-raising literature to which the financial statements may be compared to determine consistency (for example, in the timing of income and costs relating to appeals, or expenditure on special projects). In addition minutes of trustees' meetings should reflect major issues, events and decisions in the period under review and will provide valuable information in relation to reviewing the financial statements.

169. A particular area for attention concerns restricted funds (including endowments) which are subject to specific trusts as to their application. Auditors consider the disclosure of such restricted funds, and pay particular attention to:

- any funds that are in deficit;
- any income funds which are held in illiquid assets thereby preventing application of the fund; and
- any expenditure of the capital of a permanently endowed fund.

170. Examples of points that the auditors consider as part of the overall assessment of whether the financial statements prepared on the accruals basis give a true and fair view include:

- consistency of accounting policies adopted with the Charities SORP,
- recognition of income on a gross basis,
- adequacy of analysis of incoming resources,
- allocation of costs between SoFA expenditure headings,
- capitalisation of expenditure on fixed assets,
- accounting treatment of historic or inalienable assets,
- accounting for constructive obligations.

The legal and regulatory framework of charities is such that a checklist approach to

compliance with the SORP and statutes is likely to be necessary.

## **SAS 480: SERVICE ORGANISATIONS**

### **Background note**

*The SAS requires that auditors consider the impact on the audit of an entity using a service organisation and in particular the effect on the audit risk assessment and the entity's control environment. The auditors should obtain an understanding of the terms of the service agreement and how the entity monitors the activities covered by it.*

*The SAS requires that the auditors assess their reporting responsibilities in relation to the accounting records of the entity. The auditors should assess whether sufficient audit evidence is available from the entity itself and if not what procedures can be carried out to gain evidence directly from the service organisations or the auditors of the service organisation. If the auditors use a report issued by the service organisation auditors they should consider the scope of work performed and the sufficiency and appropriateness of this report.*

*The SAS requires that, where the auditors are unable to obtain sufficient audit evidence to form an opinion on the entity's financial statements, they should :*

- *include a description of the factors leading to the lack of evidence in the basis of opinion section of their report; and*
- *qualify their opinion or issue a disclaimer of opinion on the financial statements.*

171. The use of service organisations by charities is not uncommon and includes services provided to the charity such as :

- maintenance of accounting records,
- payroll services,
- fundraising,
- custodianship of assets, and
- investment management services.

172. The charity's governing document may set out powers<sup>24</sup> for the trustees to delegate activities to outside suppliers, who may not be charities themselves. Auditors review such documents where practicable, or alternatively hold discussions with the trustees, to determine

<sup>24</sup> These powers will now often be amplified by Section 11 of the Trustee Act 2000.

whether there is authority, or presumed authority, for outsourcing. In circumstances where it appears that the trustees do not have authority to outsource certain functions, it is likely that a power will need to be obtained from the Charity Commissioners pending a change in the constitution.

173. It is not uncommon for charities to share an accounting function. In such cases the auditors consider the control arrangements for allocation of costs between such connected entities.

174. Where investment management arrangements exist, the auditors consider how trustees set investment objectives and monitor performance. The auditors also discuss 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.

175. 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,
- fundraising undertaken by agents of the charity, and
- provision of ancillary catering facilities e.g. a museum restaurant.

176. These arrangements may often be covered by specific contractual arrangements that are necessary to ensure charitable provision. Issues such as charging and admission policies and beneficiary class may be subject to contractual terms that are necessary to ensure compatibility with the charity's objectives.

## USING THE WORK OF OTHERS

### SAS 510: THE RELATIONSHIP BETWEEN PRINCIPAL AUDITORS AND OTHER AUDITORS

#### **Background note**

*The SAS establishes standards and provides guidance to both principal auditors and other auditors regarding the use by principal auditors, reporting on financial statements of an entity, of other auditors' work on the financial information of one or more components included in the financial statements of the entity.*

177. Some charities operate through local branches, subsidiaries or other administrative units whose financial reports are audited or examined by local auditors. In these circumstances, the principal auditors' planning of the audit of the charity as a whole includes the following considerations:

- the materiality of the results of the branches in the context of the financial statements as a whole;
- the quality, nature and timing of the information available from the local branches;
- rights to information and explanations from the auditors of branch or subsidiary operations under the Companies Act 1985, or equivalent rights; and
- the nature of the mandate and work undertaken by the local auditor, or other person making a report in connection with the branch or subsidiary financial reports (which may range from a full audit carried out by a qualified person in accordance with SASs to an informal check by a 'lay' person) in order to determine the reliance that may be placed on the other's work.

178. Where the charity is a limited company, there is a statutory obligation on any subsidiary undertaking which is a company incorporated in Great Britain, and on its auditors, to give to the auditors of the parent company such information and explanations as they may reasonably require for the purposes of their duties.

179. Auditors of unincorporated charities in England & Wales have, under section 44(1)(d) of the 1993 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.

180. In most circumstances the principal auditors take the following steps to obtain the information necessary to form their opinion, for which they are solely responsible:

- agreeing with the trustees a standard mandate, to be issued to the secondary auditors,

covering the scope of work to be undertaken and reports to be issued;

- issuing a standard questionnaire to be completed by the subsidiary auditors; and
- obtaining a report of principal findings direct from the subsidiary auditors.

181. Where returns from the subsidiary auditors indicate a potential problem, such as qualified opinions which in aggregate could cover a substantial part of the charity's transactions, the principal auditors seek to obtain authority from the trustees to discuss the issue with the auditor(s) involved to see whether, with additional procedures, it would be possible to obtain further evidence such that an unqualified opinion can be given on the group financial statements.

# REPORTING

## SAS 600: AUDITORS' REPORTS ON FINANCIAL STATEMENTS

### **Background note**

*SAS 600 requires that an auditors' report on financial statements should contain a clear expression of opinion, based on review and assessment of the conclusions drawn from the evidence obtained in the course of the audit. The SAS also requires that an auditors' report should contain a clear expression of opinion on any further matters required by statute or other requirements applicable to a particular engagement.*

*If the auditors disagree with the accounting or disclosures in the financial statements, or the scope of their work is limited so as to prevent them from obtaining access to evidence reasonably expected to be available, the SAS requires them to issue a qualified opinion.*

182. The form and content of auditors' reports on the financial statements of charities follow the basic principles and procedures established by SAS 600. It is important to note that the operation of the Charity Commission does not extend to Northern Ireland or Scotland so that references in the auditors' report to respective responsibilities of trustees and auditors, and the wording of the opinion paragraph, will differ according to the country in which charities are established. The following paragraphs explain the variations in detail which stem from the regulatory framework within which individual charities operate.

### **Addressee of the report**

183. In the case of unincorporated charities in England and Wales the Regulations (E&W) determine that the auditors' report should be addressed to the trustees, unless the auditors have been appointed by the Charity Commission, in which case the report should be addressed to the Commission. In the case of companies and friendly societies, statute requires the auditors' report to be addressed to the members.

### **Statement of trustees' responsibilities**

184 The responsibilities of the trustees may vary according to the constitution of the particular charity. The general duties of charity trustees in relation to financial reporting are as set out in Appendix 1, but these need to be adapted to the circumstances of individual entities. Duties of trustees of charitable companies derive from the Companies Act 1985: duties of trustees of Friendly and Industrial and Provident Societies are similarly established by law. Where a charity is not subject to regulation apart from that applicable generally to charities in the country where it is based, an example of the form of words which could be used is contained in Appendix 6.

### **Compliance with relevant accounting requirements**

185. The auditors' opinion on a charity's financial statements is expressed in the context of the particular accounting requirements applicable to the charity concerned. The principal categories<sup>25</sup> are as follows:

- (a) unincorporated charities in England and Wales are required to prepare financial statements which meet the accounting requirements of the 1993 Act. The financial statements may be either:
  - (i) statements prepared under section 42(1) of the 1993 Act, following the accounting requirements set out in Regulation 3 and the Schedule to the 2000 Regulations (E&W). These include the requirement to give a true and fair view; or
  - (ii) a receipts and payments account and statement of assets and liabilities prepared under section 42(3) of the 1993 Act. There are no statutory requirements as to the form and content of the account and statement: guidance is available in the Charity Commission's publication 'Receipts and payments accounts pack 2000';
- (b) unincorporated charities in Scotland are required to prepare either:
  - (i) financial statements following the requirements of the Law Reform (Miscellaneous Provisions)(Scotland) Act 1990 (the Law Reform (MPS) Act 1990), the Charities Accounts (Scotland) Regulations 1992 and the constitution of the charity. These include the requirement to give a true and fair view; or
  - (ii) a receipts and payments account and statement of balances, prepared under section 5(3) of the Law Reform (MPS) Act 1990;
- (c) charitable companies in Great Britain are required to prepare financial statements which meet the requirements of the Companies Act 1985<sup>26</sup>. These include the requirement to give a true and fair view.

### **Requirements of the Charities Act 1993**

186. The Regulations (E&W) require trustees of larger charities to prepare an annual statement of accounts which consists of a balance sheet and statement of financial activities, together with accompanying notes, and which gives a true and fair view of the state of affairs of the charity at the end of the financial year and of its incoming resources and application of resources for that year. The Regulations(E&W) require the auditors to state whether in their opinion the charity's statements of accounts give such a view.

187. The Regulations (E&W) specifically require accounts to be prepared in accordance with the methods and principles set out in the Charities SORP. A number of specific disclosure

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<sup>25</sup> See also paragraphs 21-22 of Appendix 1.

<sup>26</sup> Northern Ireland: equivalent provisions are set out in the Companies(Northern Ireland) Order 1986.

requirements are detailed in the Schedule to Regulation 3(10) of the 2000 Regulations (E&W) and also specifically linked to the Charities SORP e.g. emoluments of staff employed, particulars of grants made and particulars of related party transactions. The Charities SORP has been developed and issued following the code of practice established by the Accounting Standards Board for the production and issue of SORPs. Consequently, it provides authoritative guidance on the application of accounting standards (compliance with which is considered necessary, in all save exceptional circumstances, to meet the requirement to give a true and fair view) in a manner which takes account of the particular circumstances of charities.

188. The Schedule made under Regulation 3(10) of the 2000 Regulations (E&W) also requires trustees to state whether the financial statements are prepared in accordance with applicable accounting standards and statements of recommended practice and to give details of any material departure and the reasons. This requirement is in line with the provisions of FRS 18 – Accounting Policies. Financial statements will need to comply with the Regulations (E&W) if they are to give the true and fair view required by regulation. This provision together with the requirement to follow the method and principles of the Charities SORP means that it will normally be necessary for financial statements to comply with the requirements of the Charities SORP in order to meet the statutory requirement to give a true and fair view.

#### ***Consolidated financial statements***

189. The 1993 Act does not contain a specific requirement for the preparation of group financial statements. However, both FRS 2 'Accounting for subsidiary undertakings'<sup>27</sup> and the Charities SORP indicate that it is normally necessary for a reporting entity with subsidiary undertakings to prepare consolidated financial statements. FRS 2's explanatory material comments that the standard practice set out in the FRS is necessary because financial statements of a parent undertaking by itself do not present a full picture of its economic activities or financial position, and that consolidated financial statements are required in order to reflect the extended unit that conducts activities under the control of the parent undertaking<sup>28</sup>.

190. Paragraph 308 of the Charities SORP recognises that entities falling within the FRS 5 - Substance of Transaction- criteria for recognition as a quasi-sub subsidiary should be included in a charity's consolidated financial statements. In determining whether a charitable entity falls within the FRS 5 criteria for inclusion within group financial statements as a quasi-sub subsidiary, auditors also give consideration to the concurrence of the stated objects of the controlling and controlled charity. In particular, the benefit flows derived from the net assets of the controlled entity will be restricted by the operation of charity law to the stated objects of the charity. Where the stated objects are significantly different this will inhibit the ability of a controlling charity to derive benefit from its control. Where due to the operation of charity law a charitable entity falls outside the consolidation requirements of FRS 5, auditors consider the adequacy of

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27 FRS 2, paragraphs 19 and 20.

28 FRS 2, paragraph 59.

the disclosure of the entity as a “connected charity” in accordance with paragraph 52 of the Charities SORP.

191. It is therefore likely that the trustees of an unincorporated charity which has subsidiary undertakings will need to prepare consolidated financial statements in order to comply with accounting standards. The Charities SORP indicates that consolidated accounts need not be prepared where the gross income of the group is below the audit threshold under the Charities Act 1993.

### ***Requirements of the Companies Act 1985***

192. Charities which are incorporated under the Companies Act 1985 are required to prepare annual financial statements which give a true and fair view of the charitable company’s state of affairs at the end of the year and of its income and expenditure for that year.

193. The Companies Act 1985 requires companies to prepare financial statements which give a true and fair view. Paragraph 3(3) of Part 1, section A of Schedule 4 of this act requires the directors (trustees) to adapt the headings and subheadings of the balance sheet and profit and loss account in any case where the special nature of the company’s business requires such adaptation. The special nature of charities, particularly in relation to special trusts, will lead to adaptation of such accounts in order to reflect the legal position of such trusts and to show a true and fair view. In addition, the development and issue of the Charities SORP, which followed the ASB code of practice, provides authoritative guidance on the application of accounting standards in a manner that takes account of the particular circumstances of the charities sector.

194. FRS 18 – Accounting Policies requires trustees of charitable companies to state whether the financial statements have been prepared in accordance with the Charities SORP and, for any treatment that is not in accordance with the SORP, to give the reasons why the treatment adopted is judged more appropriate to the charity’s particular circumstances. Details also need to be given of any disclosures recommended by the SORP that have not been provided and the reasons why they have not been provided. Auditors will be aware that non-compliance with the requirements of FRS 18 ordinarily results in a qualified opinion. In this context auditors of charitable companies need to give particular consideration to the impact of non-compliance with the Charities SORP on their audit opinion. If an adverse or qualified opinion is to be avoided, auditors need to be satisfied that any alternative treatment adopted is more appropriate in order to give the true and fair view required by company law<sup>29</sup>.

195. The form of the auditors’ opinion on the financial statements of a charitable company reflects the different form of accounting appropriate to charities, as set out in the Charities SORP, and therefore includes the expression of opinion on the incoming resources and application of resources whilst retaining reference to income and expenditure.

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<sup>29</sup> Further guidance is available in Bulletin 2000/3 – Departures from SORPs for the preparation of financial statements : Guidance for auditors.

### **Other considerations**

196. Auditors of both unincorporated charities<sup>30</sup> and charitable companies are required to include an additional statement in their report on the financial statements if they conclude that

- (a) the charity has failed to keep accounting records in accordance with the relevant Act; or
- (b) the financial statements are not in agreement with the accounting records; or
- (c) necessary information and explanations have not been made available to them.

197. Where the auditors become aware of information which indicates that a transaction or transactions undertaken by the charity may have breached the charity's governing document or, say, the trusts governing a restricted fund, they consider the guidance on reporting given in SAS 120 (and in the section on SAS 120 above).

### **Examples of auditors' reports**

198. SAS 600 contains requirements for the content of auditors' reports on financial statements, including the circumstances in which additional explanatory material is necessary or the auditors' opinion is to be qualified. However, the SAS does not contain requirements for the use of specific wording by auditors in their reports, containing instead illustrative examples of reports.

199. Examples of auditors' reports on the financial statements of charities showing different legislative requirements and illustrating each of the different forms of opinion are set out in Appendix 5 to this Practice Note.

## **SAS 610(REVISED): COMMUNICATION OF AUDIT MATTERS TO THOSE CHARGED WITH GOVERNANCE**

### **Background note**

*SAS 610 (Revised) requires that auditors communicate relevant matters relating to the audit of the financial statements to those charged with governance (in the case of charities - the trustees). Such communications should be on a sufficiently prompt basis to enable the trustees to take appropriate action.*

*The SAS requires that auditors should plan with those charged with governance the form and timing of communications to them and determine whether there are particular persons to whom they should communicate certain matters.*

200. Relevant matters relating to the audit of interest to those charged with governance, include relationships that may bear on the auditors' independence and objectivity, audit

planning information, and the findings from the audit, including the auditors' views on the qualitative aspects of the charity's accounting and reporting.

201. Findings from the audit to be communicated include any material weaknesses in the accounting and internal control systems identified during the audit. The importance of internal controls to charities is explained in the section dealing with accounting and internal control systems and audit risk assessments (SAS 300). As described in the Introduction, charity trustees have responsibilities at least as onerous as those of full-time, paid directors of commercial enterprises in relation to the security of a charity's income, assets and their proper application, and are therefore likely to welcome constructive advice on internal controls from the auditors.

202. The auditors' consideration of the system of internal control is undertaken as part of the steps necessary to form an opinion on the entity's financial statements. There is no statutory or regulatory requirement for a separate report on the design or operation of a charity system of internal controls. Nevertheless, the auditors' work may identify information on the systems which would assist the trustees in seeking to establish and maintain effective and efficient systems. As trustees are required by the Charities SORP to make a statement in their Annual Report concerning risks to which a charity is exposed and their mitigation, it will be helpful if auditors communicate to the trustees as soon as practicable any material weaknesses in the accounting and internal control systems, and other matters which the auditors judge to be important and relevant to the trustees in this respect, which they find during the course of their work.

203. Auditors plan with the trustees the form and timing of communications with them and determine whether there are particular persons with whom they should communicate about certain matters. Where the trustees employ staff to carry out their executive responsibilities, auditors consider the persons to whom it would be most appropriate to address their reports. Whilst the management staff may play a central role in the direction and management of a charity, it must be remembered that such powers are delegated from the trustee body. It is therefore essential that the auditors ensure that the trustees receive a copy of their report, even if the original is addressed to the senior management of the charity. In addition, particularly in the case of larger charities, auditors ordinarily attend the meeting at which trustees consider the financial statements and representation letter, to encourage discussion of significant items or matters arising in the course of the audit.

## **SAS 620: THE AUDITORS' RIGHT AND DUTY TO REPORT TO REGULATORS IN THE FINANCIAL SECTOR**

### **Background note**

*SAS 620 'The auditors' right and duty to report to regulators in the financial sector' establishes standards and provides guidance on the circumstances in which the auditors of an entity carrying on business in the financial sector report direct to a regulator. The overall requirement of the SAS is as follows:*

*Auditors of regulated entities bring information of which they have become aware in the ordinary course of performing work undertaken to fulfil their audit responsibilities to the attention of the appropriate regulator without delay when*

*a) they conclude that it is relevant to the regulator's functions having regard to such matters as may be specified in statute or any related regulations; and*

*b) in their opinion there is reasonable cause to believe that it is or may be of material significance to the regulator.*

### **Unincorporated charities in England and Wales**

204. Auditors of unincorporated registered charities in England and Wales are required by regulation 6(5) of the 1995 Regulations (E&W) to communicate to the Charity Commission certain matters of which they become aware in their capacity as auditors of a charity. The statutory duty to report to the Charity Commission extends to charities excepted from registration but does not extend to exempt charities<sup>31</sup>. Although the title of SAS 620 refers to reports to regulators in the financial sector, the principles and essential procedures included in SAS 620 apply in respect of this statutory duty to report to the Charity Commission.

205. Regulation 6(5) of the 1995 Regulations (E&W) specifies the circumstances which give rise to a duty to report to the Charity Commission as those

*'in which the auditor has reasonable cause to believe that the matter is, or is likely to be, of material significance for the exercise, in relation to the charity, of the Commission's functions under section 8 (general power to institute inquiries) or 18 (power to act for protection of charities) of the 1993 Act.'*

206. The purpose of the statutory provisions introduced by the Regulations (E&W) is to strengthen the system of regulation of unincorporated charities in England and Wales by requiring auditors to communicate with the Charity Commission in particular circumstances, so assisting it in its supervisory functions relating to the investigating and checking of abuses within charities. This aspect of the Charity Commission's functions is defined in Section 1(3) of the Charities Act 1993. One of the key objectives set by the Charity Commission in its interpretation of this function is to identify and deal with abuse and poor practice within charities. The Charity Commission's regulatory activities involve evaluating and, where appropriate, investigating allegations and suspicions of maladministration or abuse. The Charity Commission has specific statutory powers both to institute inquiries and to act for the protection of charities.

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<sup>31</sup> 'Exempt' charities (as referred to in Appendices 1 and 9 of this Practice Note) are excluded from the Charity Commission's supervision and monitoring, and consequently their auditors are not covered by the duty to report to the Commission. Guidance is given in paragraph 48 of this Practice Note on the auditors' right to report to a relevant other regulator of an exempt charity in the public interest.

207. Auditors are only required by the Regulations (E&W) to communicate matters described as being of 'material significance' in the context of the Charity Commission's functions under section 8 (general power to institute inquiries) or 18 (power to act for protection of charities) of the 1993 Act. The Regulations (E&W) do not require auditors to perform any additional audit work as a result of the statutory duty nor are auditors required specifically to seek out breaches of the requirements applicable to a particular charity.

208. Under section 8 of the 1993 Act, the Charity Commission has the power to institute inquiries with regard to charities or a particular charity or class of charities, either generally or for particular purposes. For the purposes of any inquiry instituted under this section, the Charity Commission has powers to obtain information, which include the power to call for documents and require persons to give evidence.

209. Under section 18 of the 1993 Act, where the Charity Commission is satisfied, following the institution of an inquiry into a charity's affairs under section 8 of the Act, that there is, or has been, any misconduct or mismanagement in the administration of the charity, or that it is necessary or desirable to act for the purpose of protecting the property of the charity or securing a proper application for the purposes of the charity, it may take regulatory action by way of orders.

210. The Charity Commission's usual practice, when instituting an inquiry under section 8 of the 1993 Act, is to send a notice of this to the charity trustees. In the formal notification of an inquiry given to the trustees, a request will be made to provide the name, address and engagement partner of their current auditors to enable a copy of the notification to be copied to them. In rare cases, sending a formal notice of the institution of an inquiry to the trustees would have an adverse effect on the conduct of the inquiry. In these circumstances, the auditors cannot be criticised for conducting their audit in ignorance of the fact that an inquiry is in progress.

***Criteria for determining the existence of a duty to report to the Charity Commission in the case of unincorporated charities in England and Wales***

211. Determining whether a matter is reportable under Regulation 6(5) of the 1995 Regulations (E&W) 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 Commission.

212. As noted above, the Regulations (E&W) do not require auditors to perform any additional audit work as a result of the statutory duty nor are auditors required specifically to seek out breaches of the requirements applicable to a particular charity. However, in circumstances where auditors identify that a reportable matter may exist, they carry out such extra work, as considered necessary, to determine whether the facts and circumstances give them 'reasonable cause to believe' that the matter does in fact exist. It should be noted that the auditors' work does not need to prove that the reportable matter exists.

213. SAS 620.4 requires that, where an apparent breach of statutory or regulatory requirements comes to the auditors' attention, they should obtain such evidence as is available to assess its implications for their reporting responsibilities and determine whether, in their opinion, there is reasonable cause to believe that the breach has occurred and that it relates to a matter that is of material significance to the regulator.

214. 'Material significance' is defined by paragraph 14 of SAS 620 as follows:

*"The term 'material significance' requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator."*

215. '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 an entity, it may be of a nature or type that is likely to change the perception of the 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 Charity Commission's consideration of whether the person concerned should be allowed to continue to act as a charity trustee.

216. The statutory duty on the auditors to report to the Charity Commission will primarily arise from the identification of a significant loss or misapplication of a charity's property or funds or from the identification of a significant risk to the charity's property or funds resulting from maladministration or mis-use of assets. Examples of the types of matter which the Charity Commission has indicated are likely to be of material significance are set out in Appendix 8 of this Practice Note.

217. The determination of whether a matter is, or is likely to be, of material significance to the Charity Commission inevitably requires auditors to exercise their judgment. In forming such judgements, auditors need 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.

218. Auditors of charities base their judgment of 'material significance' to the Charity Commission solely on their understanding of the facts of which they are aware without making any assumptions about the information available to the Charity Commission in connection with any particular charity.

219. 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'. SAS 620 however requires auditors of regulated entities, when reporting on their financial statements, to review information obtained in the course of the audit and to assess whether the cumulative effect is of 'material significance' such as to

give rise to a duty to report to the regulator. In circumstances where auditors are uncertain whether they may be required to make a report or not, they consider taking legal advice.

220. Where a situation is identified and the auditors, having considered the guidance provided in this section of the Practice Note and in Appendix 8, remain uncertain as to whether the matter is likely to be of 'material significance' the auditors may wish to discuss the circumstances giving rise to their concern with the Charity Commission. Such discussions can be used only to clarify those matters that the Charity Commission considers as routinely falling within its investigatory function. Whilst such discussions may help inform auditors in reaching their conclusion as to whether a particular matter is likely to fall within the Charity Commission's regulatory function, it is not used as substitute for the auditors' own judgement. Such discussions do not remove the need for a written report where the matter is considered to be reportable.

221. On completion of their investigations, auditors ensure that the facts and circumstances, and the basis for their conclusion that these are, or are likely to be of 'material significance' to the Charity Commission, are adequately documented such that the reasons for their decision to report may be clearly demonstrated should the need to do so arise in future.

222. Whilst confidentiality is an implied term of auditors' contracts with a charity or other entity, in the circumstances described in Regulation 6(5) of the 1995 Regulations (E&W), it does not prevail since auditors are required to communicate information or opinions on a matter relating to the affairs of the charity without contravening any duty to which they may be subject. The protection afforded is given in respect of information obtained in their capacity as auditors.

223. In addition, auditors who cease to hold office, for any reason, as a charity's auditors are required by Regulation 6(6) of the 1995 Regulations (E&W) to make a statement as to whether there are any matters concerning their ceasing to hold office which should be brought to the attention of the trustees and to send a copy of their statement to the Charity Commission.

### ***Conduct of the audit***

224. SAS 620.3 requires auditors to ensure that all staff involved in the audit of a regulated entity 'have an understanding of (a) the provisions of applicable legislation, (b) the regulator's rules and any guidance issued by the regulator, and (c) any specific requirements which apply to the particular regulated entity, appropriate to their role in the audit and sufficient (in the context of that role) to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator.'

225. Auditors include procedures within their planning process to ensure that members of the audit team have sufficient understanding (in the context of their role) to enable them to recognise breaches, and that such matters are reported to the audit engagement partner without delay so that a decision may be made as to whether a duty to report arises.

226. Individual members of the audit team will have differing levels of experience of charity audits. All staff involved in a charity audit require a broad understanding of:

- the general principles of the Charities SORP ( paragraphs 33 to 55);
- the objects of the charity as set out in the governing document of the particular charity;
- an overview of the legal responsibilities and duties of charity trustees as set out in paragraphs 44 to 47 of Appendix 1;
- the standards and guidance in SAS 620, and in this section and Appendix 8 of this Practice Note.

Further understanding, commensurate with the individual's role and responsibilities in the audit process, is required of:

- The Charities SORP;
- the governing document of the charity;
- the legal and regulatory framework in which charities and their trustees operate sufficient to meet the requirements of Auditing Standards. An overview of the legal and regulatory framework is set out in Appendix 1 and in the Introduction section of this Practice Note.

### **Connected entities**

227. Auditors will need to be aware that the duty to report extends to any institution or body corporate connected with the charity<sup>32</sup>. The 1995 Regulations do not provide auditors of the connected entity with specific relief from any duties of confidentiality that they may owe to the connected entity, and difficulties may therefore arise with respect to confidentiality unless arrangements for communicating to the charity's auditors are in place.

228. The charity auditors decide whether there are any matters to be reported to the Charity Commission relating to the affairs of the charity in the light of the information that they receive about the connected entity for the purpose of auditing the financial statements of the charity. If the charity auditors are aware of possible circumstances that may fall due to be reported, they may wish to obtain further information direct from the management or auditors of the connected entity to ascertain whether the matter should be reported. To facilitate such possible discussions, at the planning stage of the audit, the auditors of the charity will have considered whether arrangements need to be put in place to allow them to communicate with the management and auditors of the connected entity (see paragraph 99 in the SAS 200 section). If the auditors of the charity are unable to communicate with the management and auditors of the connected entity to obtain further information concerning the circumstances

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32 'Connected' is defined by Regulation 2 of the 1995 Regulations (E&W) to include 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).

they have identified they report the circumstances, and that they have been unable to obtain further information, direct to the Charity Commission.

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

229. There may be circumstances where it is not clear whether information about a charity coming to the attention of the auditors is received in the capacity of auditor or in some other capacity, for example as general adviser to the charity. Appendix 2 to SAS 620 provides guidance as to how information obtained may be relevant to the auditors 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. Matters that are potentially of material significance to the regulator, and which arise in this context should be considered and if appropriate reported, in accordance with SAS 620.

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

230. The trustees are the persons principally responsible for the management of the charity. Auditors will therefore normally bring a matter of “material significance” to the attention of the trustees and seek agreement on the facts and circumstances. However, SAS 620.5 stresses that where the auditors conclude that a duty to report arises they should bring the matter to the attention of the regulator without undue delay. The trustees may wish to report the matters identified to the Charity Commission 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 auditors of the statutory duty to report directly to the Charity Commission.

231. The Charity Commission has indicated that where a matter that is potentially of material significance is identified by the auditors, but has already been rectified by the trustees, then a reporting duty will not arise unless there has been significant pecuniary loss to the charity or the matter casts doubt on the honesty and integrity of the trustees. If the auditors are uncertain as to whether a matter has been rectified it would be advisable to report to the Charity Commission.

### ***Auditors’ right to report to the Charity Commission***

232. In the case of unincorporated charities in England and Wales, the circumstances giving rise to a duty to report are equivalent to those applicable to regulated entities in the financial sector. In the financial sector a separate statutory right (as opposed to a duty) to report to the appropriate regulator also exists and may be used by auditors. A statutory right to report where there is no statutory duty does not exist in relation to unincorporated charities.

### ***Contents of a report to the Charity Commission***

233. The Charity Commission has indicated that a report concerning a matter of material significance should be sent to the “reporting officer” at the relevant office of the Charity Commission. SAS 620.8 provides details of the information that should be included in a report to a regulator. The Charity Commission has indicated that a report should follow the format provided by SAS 620, that is to:

- state the name of the charity and its registration number;
- state that the report is made under regulation 6(5) or (6) of the 1995 Regulations (E&W);
- state that the report is prepared in accordance with SAS 620;
- describe the context in which the report is given;
- describe the matter giving rise to the report;
- request that the Charity Commission confirms that the report has been received; and
- state the name of the auditors, the date of the report, the date of any verbal report made to the Charity Commission and the name of the officer to whom the report was made.

234. The report is required to be in writing. Auditors are not relieved of their duty to make a written report where an oral report has been previously made to the Charity Commission or by any informal discussions of the issue with Charity Commission staff. Similarly, auditors are not relieved of their duty to report on the basis that any other party has provided relevant information, whether written or oral, to the Charity Commission.

235. The report sets out such information as is relevant to a proper understanding of the matter reported. It explains how the matter was identified, and the extent to which it has been investigated and discussed with the charity's trustees. The report also describes any steps taken by the trustees to rectify the reportable matter.

236. Where trustees wish to make a submission to the Charity Commission as to the circumstances and steps being taken to address a reportable matter, the auditors may attach such a memorandum or report prepared by the trustees to their report. Where such additional information is provided auditors refer to the additional information in their report, and indicate whether or not they have undertaken additional procedures to determine whether any remedial actions described have been taken.

### ***Timing of a report***

237. The duty to report arises once auditors have concluded that there is reasonable cause to believe that the matter is or is likely to be of material significance to the Charity Commission's regulatory function. In reaching their conclusion auditors may wish to take appropriate advice and consult with colleagues or lawyers.

238. The report should be made without undue delay once a conclusion has been reached. Unless the matter casts doubt on the integrity of the trustees this should 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 auditors to conclude on the matter without undue delay.

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

239. Where auditors of an unincorporated charity in England and Wales become aware of a matter, which they have reasonable cause to believe is or is likely to be of material significance to the Charity Commission's regulatory function, a duty arises under a statutory requirement and SAS 620 to report. Alleged failures to comply with Regulation 6(5) of the 1995 Regulations (E&W) is regarded as a matter for the professional bodies to deal with pursuant to their own disciplinary procedures. For cases where the Charity Commission has decided to make a complaint it has indicated that, within any legal restrictions that may apply, it will make available to those professional bodies any relevant information in its possession.

### ***Auditors' right to report in relation to charitable companies***

240. The Charity Commission's regulatory powers to institute inquiries and to act for the protection of charities also extends to charitable companies. The statutory duty to report to the Charity Commission, and hence the statutory protection with respect to duties of confidentiality, do not however extend to auditors of charitable companies. In the absence of the statutory duty auditors of charitable companies consider whether a matter identified may be one that ought to be reported in the public interest. Guidance on the factors to be taken into account when exercising their right to report in the public interest is set out in SAS 120 Consideration of law and regulations<sup>33</sup>. When considering whether to exercise their right to report auditors will have regard to the examples of matters that would be routinely investigated by the Charity Commission which are included in Appendix 8 of this Practice Note. Auditors may need to take legal advice before making a decision on whether a matter should be reported in the public interest.

241. Although charitable companies are not covered by the provisions of the Regulations (E&W), the Department of Trade and Industry has confirmed its intention to change the Companies Act to bring such companies onto an equal footing with other charities. This will be addressed as part of the major Companies Bill which is likely to follow the final report of the Company Law Review Steering Group.

### ***Auditors' right to report in relation to unincorporated charities in Scotland and Northern Ireland***

242. The statutory duty to report to the Charity Commission, and hence the statutory protection with respect to duties of confidentiality, do not extend to auditors of unincorporated charities in Scotland and Northern Ireland. In the absence of the statutory duty auditors consider whether a matter identified may be one that ought to be reported to a proper authority in the public interest<sup>34</sup>. Guidance on the factors to be taken into account when exercising their right to report in the public interest is set out in SAS 120 Consideration of law

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<sup>33</sup> Paragraphs 62-69.

<sup>34</sup> Auditors of charities based in Scotland have a right, as members of the public, to report to the Lord Advocate under section 12 of the Law Reform (MPS) Act 1990.

and regulations. When considering whether to exercise their right to report to an appropriate authority auditors of charities established in Scotland or Northern Ireland will have regard to the examples of matters that would be routinely investigated by the Charity Commission which are included in Appendix 8 of this Practice Note. Auditors may need to take legal advice before making a decision on whether a matter should be reported in the public interest.

## **SUMMARY FINANCIAL INFORMATION AND SUMMARISED FINANCIAL STATEMENTS**

243. Many charities publish financial information in a format different from the statutory financial statements. This is usually in the annual report or annual review, but may also occur in other instances such as fund raising literature. In this connection it should be noted that the auditors' report is not reproduced in conjunction with any accounts other than the complete financial statements reported on by the auditors.

244. The accounting requirements of the 1993 Act do not extend to such summarised information. Trustees of charities which are not limited companies may therefore produce summarised financial statements on an extra-statutory basis, whilst in the case of charitable companies the specific provisions of the Companies Act 1985 concerning non-statutory financial statements apply.

245. The Charities SORP distinguishes between summary financial information, and summarised financial statements. The table below sets out the differences :

| Characteristics of :   |  |
|--|--|
| Summarised financial statements  | Summary financial information                          |
| Includes information on the Statement of Financial Activities (SoFA) and balance sheet.  | May only refer to parts of either.                     |
| Derived from a set of full annual financial statements, whether or not audited/examined. | May be based on mid-year or very draft figures.        |
| Represents an account in any form purporting to be a balance sheet or SoFA.              | Makes no reference to these statements.                |
| Represents the group, or a branch.   | Represents just part of the activities of the charity. |

### ***Unincorporated charities***

246. The Charities SORP (paragraphs 292 to 296) sets out general principles for the preparation of summarised financial statements.

247. Summarised financial statements are to be accompanied by a statement, signed on behalf of the trustees, indicating:

- that they are not the statutory accounts but a summary of information relating both to the SoFA and the balance sheet,
- whether or not the full financial statements from which the summary is derived have as yet been externally examined (whether audit, independent examination, or reporting accountants' report),
- where they have been externally examined, whether there was an unqualified report,
- where the report is qualified, or contains an explanatory paragraph, sufficient details are provided in the summary financial information to enable the reader to appreciate the significance of the report,
- where branch accounts are produced, that the summary is for the branch only and has been extracted from the full accounts of the main charity (giving its name),
- how the full annual accounts, the external examiners' report (as applicable) and the trustees' report can be obtained,
- the date on which the annual accounts were approved, and
- for charities registered in England and Wales, whether or not the annual report and accounts have been submitted to the Charity Commission.

There is no statutory requirement for the auditors of an unincorporated charity to report on summarised financial statements. However, if the full financial statements have been audited the Charities SORP recommends that the auditors attach a statement giving an opinion as to whether or not the summarised financial statements are consistent with the full financial statements.

248. When a report on summarised financial statements is to be provided in addition to a report on the full financial statements, auditors carry out procedures to establish that the summarised financial statements are consistent with the full financial statements.

249. Matters which may give rise to an inconsistency include:

- information which has been inaccurately extracted from the annual financial statements and Trustees' Report;
- the use of headings in the summarised financial statements that are incompatible with the statutory headings in the full annual financial statements from which they are derived;
- information which, in the auditors' opinion, has been summarised in a manner which is not consistent with the annual financial statements (for example, if the summary is unduly selective); and

- omission from the summarised financial statements of information which is not specifically required by any regulations but which, in the auditors' opinion, is necessary to ensure consistency with the annual financial statements (for example, omission of information relating to an exceptional item or a non-adjusting subsequent event which the auditors consider fundamental to a reader's understanding of the charity's results or financial position).

250. If the auditors' opinion on the full financial statements was qualified or the basis of opinion section of the report included an explanatory paragraph, the auditors consider whether the trustees' statement accompanying the summarised financial statements gives enough details to enable the reader to understand the significance of the auditors' report. They may also wish to include an explanatory paragraph in their report on the summarised financial statements.

251. If the auditors are not satisfied, after discussion with the trustees, that the description given in the trustees' statement describes their report adequately, the principle of association in *The Auditors' Code* published by the APB indicates that the auditors will not issue a report to be included with the summarised financial statements in respect of which they consider that any qualification or explanatory paragraph in the original audit report is inadequately described.

252. If, in the auditors' opinion, the summarised financial statements are inconsistent with the full financial statements they state this fact in their report. An example of the auditors' statement on summarised financial statements is included in Appendix 5. In addition, either where trustees publish inconsistent summarised financial statements, or the auditors' statement on these is to be qualified, the auditors consider whether this is a matter reportable to a regulator in accordance with SAS 120 or SAS 620.

253. Charities may issue other summary financial information which is not based on the full financial statements approved by trustees. This may include, for example, interim figures on a fund-raising appeal or on a project. Whilst the Charities SORP requires a statement by the trustees to accompany such financial information, there is no requirement for auditors to review such information and they will only do so if their names are to be associated with it in any way, in accordance with the principles discussed in the section on SAS 160. However auditors may find it useful to refer to these documents as part of the process of obtaining knowledge of the charity in accordance with SAS 210.

254. Where a charity prepares summary financial information which does not purport to be summarised financial statements, then the trustees may ask the auditors to prepare a form of report other than that specified in this Practice Note and the SORP. The form of such wording is beyond the scope of this Practice Note.

### ***Charitable companies***

255. Charitable companies are required to send copies of the full financial statements to all members<sup>35</sup>. Where auditors are requested to report on additional summarised financial statements published by a charitable company, they take account of the guidance set out above in relation to unincorporated charities, the guidance included in Bulletin 1999/6, and the requirements of the Companies Act 1985 concerning the publication of non-statutory accounts<sup>36</sup>.

### ***Industrial and Provident Societies***

256. There are no statutory provisions in respect of summary financial information or statements produced by industrial and provident societies. However the Charities SORP applies to all charities in the United Kingdom and therefore the principles applying to unincorporated charities are applicable.

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35 Exemption from this requirement is available only to listed companies, which may send instead a summary financial statement to members, and provide full financial statements only on request – section 251 of the Companies Act 1985. NB – a charity cannot be a public company.

36 Section 240 of the Companies Act 1985.

## CHARITY ACCOUNTING AND AUDIT REGULATIONS IN THE UNITED KINGDOM

### The Regulatory Framework

| Nature of control                        | England & Wales   | Scotland                                       | N.Ireland   |
|--|---|--|---|
| Registration (if not excepted or exempt) | The Charity Commission  | N/A  | N/A   |
| Recognition                              | The Charity Commission/Inland Revenue   | Inland Revenue                                 | Inland Revenue  |
| Reporting                                | To the Charity Commission<br><br><i>Routine:</i> registered charities<br><br><i>By exception:</i> excepted charities<br><br><i>Not at all:</i> exempt charities | By exception, to the Scottish Charities Office | By exception, to the Charities Branch in Northern Ireland |

1. The term 'regulatory framework' is used in a general sense in this document. In England and Wales the Charities Act 1993 provides the primary legislative framework for charity regulation by the Charity Commission. In particular the Charity Commission is responsible for the registration, supervision and regulation of charities that are not exempt. All charities, except some of the very smallest (whose gross income does not exceed £1,000, and which do not have a permanent endowment nor use nor occupy land), exempt charities and certain other classes of charity that have been excepted from registration must register with the Charity Commission. A public register of charities is maintained.
2. Under the 1993 Act, the Charity Commissioners 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 charities incorporated under general legislation, and therefore to auditors and reporting accountants of charitable companies as well as to auditors and independent examiners appointed under the 1993 Act. Certain types of charity may also be monitored by other bodies, for example by the Housing Corporation in the case of charitable registered social landlords in England.

3. Supervision of Scottish charities is carried out of behalf of both the Lord Advocate and Ministers of the Scottish Parliament by the Scottish Charities Office; an administrative arrangement within the Crown Office which was put in place to facilitate the Lord Advocate's/Scottish Ministers' functions under the 1990 Act. The Scottish Charities Office has the power to investigate misconduct or mismanagement in the administration of charitable organisations. Charities are recognised for tax purposes by the Inland Revenue and a public index is maintained of charitable bodies. Charities in Scotland are therefore described in Scottish legislation as 'recognised bodies', although branches of English/Welsh charities operating in Scotland may describe themselves as 'registered charities' as they are deemed to be 'charities' under Scottish legislation. Under the Law Reform (MPS) Act 1990 the Lord Advocate or his nominated officers may require any person whom he has reason to believe has relevant information to answer questions or otherwise furnish information with respect to any matter relevant to an investigation into the affairs of a charity. Such a person may include the auditors or independent examiners.
4. In Northern Ireland the Charities Branch of the Voluntary Activity Unit of the Department for Social Development is the body responsible for charities. Charities are recognised for tax purposes by the Inland Revenue. The regulatory framework under which charities operate is provided primarily by the Charities Act (Northern Ireland) 1964 and the Charities (Northern Ireland) Order 1987. Under section 3 of the Charities Act (Northern Ireland) 1964 the Department for Social Development (formerly the Department of Health and Social Services) may, with the consent of the Attorney-General, require any person having in his possession any documents relating to a charity to give the documents (or copies) to the Department if it has reason to believe that the charity's property may have been concealed, misapplied or withheld. The legislation is widely drawn and would cover both audit clients' documents held and auditors' own working papers.
5. Certain charities in England and Wales are excepted from registration with the Charity Commission by order or regulation. Examples include certain religious charities, armed forces charities wholly or mainly concerned with the promotion of efficiency of the armed forces and some Scout and Guide groups. Excepted charities do not have to submit accounts (except on request) or annual returns, but in most other respects are fully within the Charity Commission's jurisdiction. They are required to prepare accounts and are subject to the same audit or examination requirements as they would be if registered and can be required under s.46 of the Act to prepare an annual report and submit it together with the accounts for the year.
6. Exempt charities in England and Wales are specifically excluded from the Charity Commission's supervision and monitoring. Exempt charities do not register with the Charity Commission, nor do they submit accounts and annual returns. Such charities can seek advice and apply for Schemes and most enabling orders. Exempt charities are listed in Schedule 2 of the 1993 Act and are generally subject to their own statutory and regulatory provisions other than the 1992 and 1993 Acts. Examples include universities, many maintained schools, and many national museums and galleries.

7. Registered societies within the meaning of the Friendly Societies Act 1974 or the Industrial and Provident Societies Act 1965 in England and Wales are also exempt charities under Schedule 2 of the 1993 Act (This exemption does not extend to charities which are administered by a registered society or to other charities which have a registered society as a subsidiary). As exempt charities, friendly societies or industrial and provident societies are not generally affected by the accounting provisions of the 1993 Act; specific accounting and auditing requirements are provided by the legislative framework applicable to such societies.
8. There are relatively few remaining charitable friendly societies - the Financial Services 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. Societies can be incorporated under the Friendly Societies Act 1992 but the purposes defined in Schedule 2 of this Act are unlikely to be charitable. A charitable incorporated society is not an exempt charity. A number of charities, primarily Registered Social Landlords<sup>37</sup>, are constituted as industrial and provident societies. Housing associations may register with the Housing Corporation, Scottish Homes, or Tai Cymru under the Housing Acts 1965.
9. In Scotland, charities which are registered under the Friendly Societies Act or the Industrial and Provident Societies Act are still subject to the provisions of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 unless they are specifically exempted, notably registered housing associations. Housing associations in Northern Ireland register under the Industrial & Provident Societies Act (Northern Ireland) 1969, and are also required to register with the Department of the Environment.

### **PRIMARY LEGISLATION**

|  | <b>U.K.-wide</b>  |                                      | <b>England &amp; Wales</b>   | <b>Scotland</b>                               | <b>N.Ireland</b>                      |
|--|---|--------------------------------------|------------------------------|---|---------------------------------------|
| Companies Act 1985 and 1989 or Northern Ireland equivalent | Industrial and Provident Societies Acts 1965 to 1978 (or Northern Ireland equivalent) <sup>38</sup> | Friendly Societies Acts 1974 to 1992 | Charities Acts 1992 and 1993 | Law Reform (Misc. Prov's) (Scotland) Act 1990 | Charities Act (Northern Ireland) 1964 |
|  | Housing Associations Act 1985   |                                      |                              | Trusts (Scotland) Acts 1921 and 1961          |                                       |
|  | Housing Act 1988  |                                      |                              |   |                                       |
|  | Housing Act 1996  |                                      |                              |   |                                       |

<sup>37</sup> See Practice Note 14- The audit of registered social landlords.

<sup>38</sup> By virtue of the Industrial and Provident Societies Act 1978, s 3(2), this Act, the Industrial and Provident Societies Act 1967, the Friendly and Industrial and Provident Societies Act 1968, and the Industrial and Provident Societies Act 1975 and 1978 may be cited by this collective title.

## Principal secondary legislation applicable to unincorporated charities

| England & Wales   | Scotland  | N.Ireland                                   |
|---|---|---|
| The Charities (Accounts and Reports) Regulations 1995   | Charities Accounts (Scotland) Regulations 1992  |   |
| The Charities (Accounts and Reports) Regulations 2000   | Public Trusts (Re-organisation) (Scotland) (No 2) Regulations 1993  | The Charities (Northern Ireland) Order 1987 |
| Charities (Exemption from Registration) Regulations 1996  | Charities (Designated Religious Bodies) (Scotland) Order 1993   |   |
| Charities (Exemption of Universities from Registration) Regulations 1966<br><br>Charities (Exemption from Registration and Accounts) Regulations 1965 | The Charities (Exemption from Accounting Requirements) (Scotland) Regulations 1993 and the Amendment regulations of 1995 and 2000   |   |
| Charities (Exception of Voluntary Schools from Registration) Regulations 1960 and section 23 School Standards and Framework Act 1998                  | The Charities (Dormant Accounts) (Scotland) Regulations 1995 and the Amendment regulations of 1997<br><br>The Charities (Scheme for Transfer of Assets) (Scotland) Regulations 1992 |   |

## **ACCOUNTING AND REPORTING REQUIREMENTS**

| <b>U.K. wide</b>                           |                                    |                                    | <b>England &amp; Wales</b>   | <b>Scotland</b>   | <b>N.Ireland</b>  |
|--|------------------------------------|------------------------------------|--|---|---|
| Charitable Companies<br><br>(para in text) | Industrial and Provident Societies | Friendly Societies                 | Unincorporated<br><br>(18)   | Unincorporated<br><br>(19)  | Unincorporated<br><br>(20)  |
| Accruals basis, true and fair view         | Accruals basis, true and fair view | Accruals basis, true and fair view | Receipts and payments optional up to £100K gross income: no requirement to give true and fair view.<br>Accruals basis and true and fair view for income of £100K+. | Receipts and payments optional up to £25K income, no requirement to give true and fair view.<br>Accounts comprise statement of balances, receipts & payments account, and report on activities.<br><br>Accruals basis and true and fair view required for gross income of £25K+ . Balance sheet, income and expenditure account | Charities choose either annual receipts and payments or income and expenditure account. |

### ***The Charities SORP and UK Legal Requirements***

10. The Charities SORP is intended to apply to all charities in the United Kingdom whose financial statements are required to give a true and fair view, and for whom no more specialist SORP applies. So far as the preparation of accounts is concerned, falling within more than one regulated sector may influence the accounting requirements for a charity. Paragraph 12 of the Charities SORP (reissued in October 2000) states that, where a statement of Recommended Practice exists for a particular class of charities, the trustees of charities in that class should adhere to that SORP instead.
11. Whilst 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 relating to the form and content of accounts, such as are contained in companies legislation, the Industrial and Provident Societies Acts 1965 to 1978, registered social landlord accounting regulations for England, Wales or Scotland,

or regulations made under the Law Reform (Miscellaneous Provisions)(Scotland) Act 1990. The recommendations of the Charities SORP should also be adapted to meet any special requirements of the charity's own governing document.

12. It is not envisaged that the requirements of different regimes will be incompatible. For example, there is a general requirement under companies and friendly societies legislation in the United Kingdom for financial statements to give a true and fair view. The aim of specialist SORPs, including the Charities SORP, is to assist entities in achieving a true and fair view appropriate to their circumstances.
13. All charities in England & Wales as defined in the 1993 Act are affected in some respects by the accounting and reporting provisions of Part VI of the 1993 Act. However the way in which they are affected will depend on constitution, size and whether they are registered, excepted or exempt.

### ***Charitable Companies***

14. Charitable companies are generally incorporated as companies limited by guarantee and the requirements of the Companies Act 1985 applicable to such companies apply throughout Great Britain. The Companies Act 1985 requires companies to prepare annual financial statements which give a true and fair view of the state of affairs at the end of the year and of the profit and loss for the year. Paragraph 3 (3) of Part 1, section A of Schedule 4 of this Act requires directors to adapt the headings and subheadings of certain items in the balance sheet and profit and loss account in cases where the special nature of the company's business requires such adaptation. This provision allows for the adaptation of formats enabling Charities SORP compliant accounts to be prepared by charitable companies. Paragraphs 331 to 343 of the Charities SORP provide a detailed analysis of the impact of the Companies Act 1985 requirements on SORP compliant accounts.
15. The Companies Act 1985 requires annual accounts to give a true and fair view, which means that charitable companies, however small, may not take advantage of the provisions in England & Wales or Scotland allowing preparation on a receipts and payments basis available to unincorporated charities.
16. The charitable companies registered in England & Wales are also subject to the provisions of the 1993 Act unless its application is specifically excluded in that legislation. In particular the Part VI requirements to maintaining accounting records and for external scrutiny do not apply to charitable companies as these matters are subject to the Companies Act 1985 provisions. A requirement does exist to prepare and file with the Charity Commission an annual report in accordance with Part VI. The financial statements and audit or accountants report (if any) which are prepared under Part VII of the Companies Act 1985 are annexed to the annual reports prepared under section 45 of the 1993 Act. It may be possible for the directors' report prepared under the Companies Act to be amplified in such a way that it also meets the annual report requirements of the Charities Act.
17. All aspects of the Law Reform (MPS) Act 1990 affect charitable companies in Scotland apart from the accounting and external scrutiny requirements which are covered by the Companies Act 1985.

### ***Unincorporated Charities in England and Wales***

18. The accounting and reporting requirements are set out in Part VI of the 1993 Act and the 2000 Regulations (E&W). These regulations do not apply to exempt charities, but apply to all other unincorporated charities except unregistered charities with gross income of £1000 or less, that have no permanent endowment nor use or occupy land. Whilst all charities must prepare accounts, the impact of these regulations depends on the threshold requirements as set out in the 1993 Act and on whether the charity is registered or not. These requirements can be summarised as follows:

- registered charities with gross income and total expenditure of £10,000 or less, and excepted charities which are not registered, are not required to submit annual reports or accounts to the Charity Commission, unless requested to do so. All registered charities must prepare an annual report, even if they are not requested to submit it to the Charity Commission;
- charities with gross income of £100,000 or less may prepare a receipts and payments account and a statement of assets and liabilities;
- charities that exceed this £100,000 threshold must prepare accounts on an accruals basis to give a true and fair view. Certain additional disclosure requirements are placed on charities whose gross income exceeds £250,000.

### ***Unincorporated charities in Scotland***

19. The accounting and reporting requirements are set out in Sections 4 and 5 of The Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 and the Charities Accounts (Scotland) Regulations 1992. These requirements can be summarised as follows:

- Charities with gross receipts not exceeding £25,000 per annum can elect to prepare a receipts and payments accounts and a statement of balances;
- Charities with gross receipts over £25,000 must produce accounts on an accruals basis;
- All charities must produce annual accounts which are available to the Lord Advocate and to members of the public on request together with an explanation of their objectives.

### ***Unincorporated Charities in Northern Ireland***

20. The regulation of charities in Northern Ireland is governed mainly by the Charities Act (Northern Ireland) 1964 and the Charities (Northern Ireland) Order 1987.

### ***Exempt Charities***

21. The accounting and reporting requirements of exempt charities will be dependent on how such charities are constituted and any specific statutes or regulations applying to them. If constituted as a company then company law will be applicable. If constituted as a friendly or industrial and provident society then the requirements placed on such societies will apply.

22. The accounting requirements for Industrial and Provident Societies are set out in the Friendly and Industrial and Provident Societies Act 1968, which require accounts to be prepared giving a true and fair view. All Industrial and Provident societies are required to submit an annual return, including the accounts, which are public records. Similar provisions apply to charitable societies registered under the Friendly Societies Act 1974.

## REQUIREMENTS FOR EXTERNAL SCRUTINY OF FINANCIAL STATEMENTS

*(The constitution of the charity may impose heavier requirements than, but not derogate from, the following rules)*

| INCORPORATED   |  | UNINCORPORATED  |   |  |  |
|--|--|---|---|--|--|
| U.K. wide  |  | U.K. wide   | England & Wales   | Scotland   | N.Ireland  |
| (para in text) (23)  |  |   | (30)  | (35)   | (41)   |
| Total exemption for gross income up to £90k and balance sheet total less than £1.4m. Audit exemption report for income of more than £90k and less than £250k. Audit required for charities with income of more than £250k or balance sheet total greater than £1.4m. | Charitable Industrial and Provident Societies exempt if turnover less than £90k. Audit exemption report if turnover more than 90k and less than £250k and total assets less than £1.4m. Audit required above this threshold (exemption not available to Housing Associations or if there is a subsidiary). | Audit required for all "charitable" friendly societies except where both receipts and payments in aggregate and assets do not exceed £5k and there are fewer than 500 members. Below this threshold lay auditors may be appointed. Charitable societies registered under Friendly Societies Act 1974 may opt for exemption on same basis as Industrial and Provident Societies. | No external scrutiny where both gross income and total expenditure are not more than £10k. Independent examination required where gross income or total expenditure between £10k and £250k. Audit required where income or expenditure within the current or either of the two preceding years exceeds £250k. | Independent examination where income is up to £100k (unless audit required by constitution). Audit required where income or expenditure within the current and the two preceding years is £100k or more. | No statutory requirements specific to N.Ireland. |

## ***Audit of charitable companies***

### ***Audit Thresholds***

23. Under sections 249A to 249E of the Companies Act, charitable companies whose gross income does not exceed £250,000 (and whose gross balance sheet total does not exceed £1.4 million) are potentially exempt from statutory audit if they are stand-alone companies (i.e. they do not have subsidiary undertakings, and are not themselves subsidiary undertakings) or, if not stand-alone, they are dormant in the period subject to audit. Even if a charity does not meet the above criteria, it may still be exempt if the group of which it is a member qualifies as a small group by reference to s 249 of the Act and if its aggregate turnover does not exceed £350000 net (or £420000 gross) and if its balance sheet total does not exceed £1.4m net (or £1.68m gross) during the accounting period concerned. Where a qualifying company has annual gross income between £90,000 and £250,000, the audit exemption is conditional on obtaining from a reporting accountant a report on the matters specified in section 249C of the Companies Act 1985. Charitable companies are not subject to the accounts/audit/independent examination requirements of the 1993 Act.

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

24. The 1985 Companies Act and Northern Ireland Accounting Requirements Order give the right of access for company auditors, or reporting accountants, to such information and explanations as they consider necessary for the discharge of their duties. It is an offence for an officer of a company knowingly or recklessly to make to the auditor or reporting accountant a statement which is misleading, false, or deceptive in a material particular.

### ***Form and Content of Auditors Report***

25. Auditors of charitable companies report under the requirements of the Companies Act 1985. In addition to forming an opinion on the financial statements certain additional responsibilities arise where:

- the directors' report is inconsistent with the financial statements;
- proper accounting records have not been kept or adequate returns from branches have not been received;
- accounts are not in agreement with accounting records and returns;
- all information and explanations necessary for the purposes of the audit has not been obtained; and
- the disclosure requirements of Schedule 6 of the 1985 Act are not met.

### ***Other Reporting Rights and Duties***

26. Under section 394 of the Companies Act 1985 auditors must deposit at the company's registered office a statement of circumstances connected with their ceasing to hold office for any reason, which they consider should be brought to the attention of members or creditors of the company. If they consider that there are no such circumstances, they must deposit a

statement to this effect.

27. Under section 391A of the Companies Act 1985, auditors have the right to make representations to the members in general meeting if there is a resolution to remove them before the expiry of their term of office.

## **Audit of Unincorporated Charities in England and Wales**

### ***Audit requirements and thresholds***

28. The audit or independent examination requirements and thresholds in England & Wales are set out in Part VI of the 1993 Act<sup>39</sup>; the duties placed on auditors and independent examiners are set out in the Regulations (E&W), and in the Charity Commission's directions under section 43(7). Independent examination<sup>40</sup> is a less onerous form of external scrutiny introduced by the 1993 Act. The requirement for external scrutiny and the nature of the scrutiny depends on income and expenditure thresholds set by the 1993 Act.

29. A charity's governing document may require an audit, even though the 1993 Act gives the charity the option of independent examination. In such circumstances the trustees may wish to approach the Charity Commission with a view to amending the requirement of the governing document to bring it in line with statutory provisions. Where the intention of the governing document is ambiguous in terms of the level of scrutiny required the trustees may seek the advice of the Charity Commission or seek to amend the relevant clause in line with the requirements of the 1993 Act.

30. The threshold requirements of the 1993 Act can be summarised as follows:

- Where both gross income and total expenditure do not exceed £10,000 there is no statutory requirement for either an audit or an independent examination;
- Where neither gross income nor total expenditure exceeds £250,000 in the current year or in either of the two preceding financial years an election may be made for the accounts to be independently examined;
- If gross income or total expenditure exceeds this £250,000 threshold in the current year or either of the two preceding financial years then a statutory audit is required;
- an audit can only be undertaken by a registered auditor, unless the Charity Commission gives a dispensation.

### ***Content of Auditors' Report***

31. Regulation 6 of the 1995 Regulations set out the matters to be included in the audit

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39 As amended by the Deregulation and Contracting Out Act 1994 (s28) and Charities Act 1993 (Substitution of Sums) Order 1995.

40 See Appendix 7 for a comparison with audit and details of the procedural basis of independent examination.

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 auditors' report are required where the opinion is formed that:

- proper accounting records have not been kept in accordance with s.41 of the 1993 Act;
- the statement of accounts does not accord with those records;
- information contained in the accounts is materially inconsistent with the trustees' annual report; or
- information and explanations considered necessary have not been provided.

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

32. Auditors or independent examiners have a right of access with respect to books, documents and other records (however and wherever kept) relating to the charity concerned; the auditor or independent examiner 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 Rights and Duties***

33. Auditors are required by regulation 6(5) of the 1995 Regulations (E&W) to report to the Charity Commission in writing if, in connection with an audit of a charity, they become aware of a matter of material significance to the Charity Commission's regulatory functions under sections 8 or 18 of the 1993 Act. A similar reporting duty is imposed on independent examiners by means of a Charity Commission Direction. Detailed guidance on the audit implications of this duty is provided in the SAS 620 section of this Practice Note.

34. In addition when auditors cease for any reason to hold office they must send to the charity trustees a statement of circumstances connected with their ceasing to hold office, which they consider should be brought to the trustees' attention or, if they consider that there are no such circumstances, a statement that there are none. A copy of the statement should be sent to the Charity Commission unless there are no such circumstances to report.

## **Unincorporated Charities in Scotland**

### ***Audit Requirements and Thresholds***

35. The Charities Accounts (Scotland) Regulations (SI 1992 No 2165) requires all unincorporated charities with gross income or expenditure over £100,000 in the current or two preceding years to be audited. Unincorporated charities with income below £100,000 can be independently examined unless a requirement for an audit appears in the constitution.

### ***Content of Auditors' Report***

36. Under the 1992 Regulations (Scotland) auditors/independent examiners are required to state in their report to trustees if they have failed to obtain adequate information and

explanations for the purpose of the assignment, or if they consider that the charity has failed to maintain proper accounting records. These provisions are broadly similar to those applicable for charitable companies in the UK.

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

37. The 1992 Regulations provide that the auditors or independent examiners 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 they think necessary for the performance of their duties.

### ***Other Reporting Rights and duties***

38. Where auditors or independent examiners resign, they must include in their notice of resignation a statement as to any circumstances connected with their resignation which they consider should be stated in the trustees' annual report.

39. Where auditors or independent examiners are removed from office they may submit a statement to the trustees setting out their observations on the circumstances of such removal and such a statement must be included in the trustees' annual report for the year in question.

40. The auditors' 'right' to report to third parties is set out in the Law Reform (MPS) Act 1990 which states in Section 5 (12): " Where any such body, within one month of its being requested to do so by any person - fails to provide to that person a copy of its most recent statement of accounts as mentioned in subsection (7) above. The Lord Advocate, on a complaint being made to him by such a person, may direct that the fact of such failure shall be noted for the purposes of Section 1(3) of this Act." Whilst the auditor is not specifically mentioned in this section, the auditor has a 'right', as a member of the public, to report to the Lord Advocate.

### ***Unincorporated Charities in Northern Ireland***

41. There is no requirement for audit under current charities legislation in Northern Ireland. Therefore there are no statutory provisions relating to auditors' rights to information and explanations. As this right is fundamental to the proper conduct of an audit in accordance with Auditing Standards, auditors who are unable to obtain all the information and explanations they consider necessary for the purposes of forming an opinion will qualify their report accordingly. Similarly no legislation covers auditors' reports to trustees.

42. Legislation does not confer any specific right on auditors to report to third parties. The auditors' right to report to third parties is referred to in guidance set out in SASs 110 and 120.

### ***Exempt Charities and Friendly and Industrial and Provident Societies***

43. The reporting rights and duties of exempt charities will be dependent on how such charities are constituted and any specific statutes or regulations applying to them. If constituted as companies then reporting rights and duties will be under the Companies Act 1985. If constituted as a friendly or industrial and provident society then the legislation

applicable to such societies will apply.

## **Responsibilities and duties of charity trustees**

44. Although the detail of regulation differs between different parts of the United Kingdom, the general principles governing the duties of trustees are the same. The charity trustees are defined in England and Wales as “the persons having the general control and management of the administration of a charity” (in Scotland the definition refers to ‘management or control’, which encompasses a far wider range of people), regardless of what they are called under the governing document. Their actions are subject to trust law and the requirements of the charity’s governing document. Trustees have the general duty of protecting all the charity’s property. They are responsible for the solvency and continuing effectiveness of the charity and the preservation of any endowments. They must exercise control over its financial affairs.

Trustee duties and responsibilities include:

- where a particular function is delegated to staff or third parties, monitoring the performance of the delegated function and clearly setting out the scope and limits of the delegated authority;
- acting in accordance with the charity’s governing document, in particular, the income and property of the charity must be applied for the purposes set out in the governing document and, in the case of any restricted fund such as an endowment fund, within the particular trusts attaching to that fund, and for no other purpose;
- acting reasonably and prudently in the charity’s interests only and without regard to their own private interests;
- not deriving remuneration or benefit personally from the charity unless explicit powers exist to do so;
- maintaining proper accounting records and preparation of accounts required by the regulatory regime under which they operate;
- being able and willing to give time to the efficient administration of the charity and the fulfilment of its trusts.

45. Trustees can be held accountable for any breach of the charity’s trusts or neglect of their fiduciary duties. Where the charity is incorporated under the Companies Act, then its directors benefit from the same protection from creditors as do directors generally. A problem which can arise in practice is that of members of staff or even professional advisers being perceived by third parties to have trustee status. Such a situation may arise where the trustees meet only infrequently and senior staff effectively make, as well as carry out, policy decisions. The considerations in these circumstances are similar to those for shadow directors of companies. A person who acts as a trustee when he or she is not one will be liable to make good any losses of the Trust as if he or she were a trustee.

46. Trustees may not profit out of transactions with the charity or receive any remuneration or

benefit from it unless there is express provision for this in the charity's governing document or the transaction is authorised by the relevant public authority. However, it is possible for senior employees, for example, to be appointed as trustees if this is provided for in a charity's governing document or is otherwise authorised. Typically, the authority will draw a clear distinction between their functions as employees, conducting the operations of the charity in accordance with the trustees' policy, for which they may be paid, and time spent acting as trustees, to which the remuneration authority would not usually extend. Similarly, professionally qualified trustees may only charge the charity for their professional services if specific provision exists to do so. The Charities SORP 2000 and the Regulations (E&W) require the accounts of a charity to disclose all trustee transactions with the charity, and trustee remuneration/benefits from the charity, whether authorised or not. The disclosure requirements are widely drawn to include a person connected with a charity trustee and companies or institutions connected with the charity (see paragraphs 157 to 170 of the Charities SORP).

47. Significant breaches of trustees duties and responsibilities identified are considered by auditors in the context of the guidance provided in the SAS 620 section of this Practice Note.

#### **Regulation specific to the Charity's area of operation**

48. The charity sector is diverse in terms of activities undertaken and the law and regulations affecting charities reflect this diversity. The SAS 120 guidance provided in this Practice Note recognises this diversity and provides guidance on charity specific legislation that may be central to the ability to operate.

49. Many charities will be involved in fund-raising activities including seeking voluntary donations. Charities will also be involved in the investment of charitable funds either where they hold endowed funds or by investing general funds prior to its expenditure. Specific legislation exists in relation to the investment of trust funds, and detailed legislation also exists in relation to fundraising activities, and street and door- to- door collections. The relevant legislation and regulations are summarised below:

| England & Wales   | Scotland   | Northern Ireland   |
|---|--|--|
| <p><b>INVESTMENT OF TRUST FUNDS</b><br/>Trustee Act 2000</p>  | <p><b>INVESTMENT OF TRUST FUNDS</b><br/>Trustee Investments Act 1961</p> <p>The Trustee Investment (Division of Trust Fund) Order 1996</p>   | <p><b>INVESTMENT OF TRUST FUNDS</b><br/>Trustee Investments Act 1961 (applied to Northern Ireland by the Trustee (Amendment) Act (Northern Ireland) 1962<sup>41</sup>)</p> <p>Charities Central Investment Fund Scheme (NI) 1965</p> <p>Charities Central Investment Fund Order 1988</p>   |
| <p><b>COLLECTIONS &amp; FUND-RAISING</b></p> <p>The Police, Factories etc (Miscellaneous Provisions) Act 1916</p> <p>House to House Collection Act 1939</p> <p>House to House Collection Regulations 1947</p> <p>Lotteries and Amusements Act 1976 (as amended by the National Lottery Act etc.1993)</p> <p>The Lotteries Regulations 1993 SI 3223</p> <p>Part II Charities Act 1992</p> <p>The Charitable Institutions (Fund-Raising) Regulations 1994</p> | <p><b>COLLECTIONS &amp; FUND-RAISING</b></p> <p>The Civic Government (Scotland) Act 1982</p> <p>Public Charitable Collections (Scotland) Regulations 1984</p> <p>Public Charitable Collections (Scotland) Amendment Regulations 1988</p> | <p><b>COLLECTIONS &amp; FUND-RAISING</b></p> <p>The Police, Factories etc (Miscellaneous Provisions) Act 1916</p> <p>Collections in Streets or Public Places Regulation 1927 and 1963</p> <p>House-to-House Charitable Collections Act (Northern Ireland) 1952</p> <p>House-to-House Charitable Collections Regulations (NI) 1952 and 1953</p> <p>Betting, Gaming, Lotteries and Amusements (NI) Order 1985</p> <p>Betting and Lotteries (NI) Order 1994</p> <p>Gaming and Lotteries (Variation of monetary limits) Order (NI) 1990</p> <p>Lotteries Regulations (NI) 1994</p> |

41 The 1961 Act is due shortly to be replaced by a new Northern Ireland Trustee Act.

### LIST OF PUBLICATIONS

**Charity Accounts and Reports: Core Guide** (produced by the Home Office). This includes a copy of the Regulations, relevant extracts from the legislation and a commentary. Copies are available from HMSO, at a cost of £11.

#### Charity Commission Publications

##### The Charities SORP

Accounting and Reporting by Charities – Statement of Recommended Practice (Charities SORP) was published in October 2000. This publication can be viewed and downloaded for free from the Charity Commission's web site. Copies can also be ordered by telephone on 01823 345427. There is a charge of £5.00 per copy for this publication.

##### Other Leaflets and Guidance

The Charity Commission also produces a range of publications, audio-cassettes and a video, which provide information about the Commission's role, the duties of charity trustees, and charity law. The current publications are listed below, and are available on the Charity Commission's web site – [www.charitycommission.gsi.gov.uk](http://www.charitycommission.gsi.gov.uk) or by ordering on answerphone number 01823 345427. The web site also provides access to model governing documents, a series of publications in relation to the current review of the register as well as useful guidance on a variety of current topics and issues.

The following list of publications is provided for reference purposes only and while a working knowledge of all the publications is useful, it is not intended that the auditors need to gain a detailed knowledge of every one. Individual publications should be referred to in detail as specific circumstances dictate.

|        |   | <b>Date of issue</b> |
|--------|---|----------------------|
| CC1    | Charity Commission Publications                                   | 8/01                 |
| CC2    | Charities and the Charity Commission                              | 7/00                 |
| CC3    | Responsibilities of Charity Trustees                              | 9/99                 |
| CC3(a) | Responsibilities of Charity Trustees: A Summary                   | 8/99                 |
| CC4    | Charities for the Relief of the Poor                              | 8/01                 |
| CC6    | Charities for the Relief of Sickness                              | 3/00                 |
| CC7    | Ex Gratia Payments by Charities                                   | 1/95                 |
| CC8    | Internal Financial Controls for Charities                         | 5/01                 |
| CC9    | Political Activities and Campaigning by Charities                 | 9/99                 |
| CC9a   | Political Activities and Campaigning by Local Community Charities | 2/97                 |
| CC11   | Payment of Charity Trustees                                       | 9/00                 |
| CC12   | Managing Financial Difficulties and Insolvency in Charities       | 1/00                 |
| CC13   | The Official Custodian for Charities' Land Holding Service        | 3/95                 |

|         |  |       |
|---------|--|-------|
| CC14    | Investment of Charitable Funds: Basic Principles                                     | 8/00  |
| CC18    | Use of Church Halls for Village Hall and Other Charitable Purposes                   | 7/01  |
| CC19    | Charities' Reserves  | 6/99  |
| CC20    | Charities and Fund-raising   | 4/01  |
| CC20(a) | Charities and Fund-raising: A Summary  | 9/99  |
| CC21    | Registering as a Charity   | 5/01  |
| CC22    | Choosing and Preparing a Governing Document  | 2/01  |
| CC23    | Exempt Charities   | 7/99  |
| CC24    | Users on Board : Beneficiaries who become trustees                                   | 3/00  |
| CC25    | Resolving Charity Disputes : Our roles   | 1/01  |
| CC27    | Providing Alcohol on Charity Premises  | 7/96  |
| CC28    | Disposing of Charity Land  | 7/00  |
| CC29    | Charities and Local Authorities  | 4/96  |
| CC33    | Acquiring Land   | 4/01  |
| CC35    | Charities and Trading  | 7/01  |
| CC36    | Making A Scheme  | 9/99  |
| CC37    | Charities and Contracts  | 3/01  |
| CC38    | Expenditure and Replacement of Permanent Endowment                                   | 4/94  |
| CC40    | Disaster Appeals: Attorney General's Guidelines                                      | 6/96  |
| CC42    | Appointing nominees and custodians   | 2/01  |
| CC43    | Incorporation of Charity Trustees  | 6/99  |
| CC44    | Small Charities : Alteration of Trusts, Transfer of Property, Expenditure of Capital | 9/00  |
| CC45    | Central Register of Charities: Services Available                                    | 2/01  |
| CC47    | Inquiries into Charities   | 2/00  |
| CC47(a) | Inquiries into charities: your rights and obligations                                | 2/00  |
| CC48    | Charities and Meetings   | 10/00 |
| CC49    | Charities and Insurance  | 6/96  |
| CC60    | The Hallmarks of a Well-Run Charity  | 2/01  |
| CC61    | Charity accounts 2001 – the framework  | 1/01  |
| CC62    | Charities SORP 2000 : What has changed?  | 5/01  |
| CC63    | Independent examination of charity accounts  | 8/01  |
| CC64    | Receipts and payments accounts pack 2000   | 11/01 |
| CC65    | Accruals accounts pack   | 8/01  |
| CC66    | SORP 2000 : Example Reports and Accounts   | 11/00 |

### ***The Scottish Council for Voluntary Organisations***

For charities recognised in Scotland, further reading matter is available from SCVO as follows:

- In Management and Control (guide for committee members and trustees)
- The Essential Advice and Information Manual for Scottish Voluntary Organisations (working title: published in October 1996)

- A Hand in Management.

## **Northern Ireland**

### ***Northern Ireland Department of Health and Social Services - Charities Branch Voluntary Activity Unit***

- Northern Ireland Charities: A guide for trustees

### ***Northern Ireland Council for Voluntary Action charity advice service***

- Notes on charitable status
- Lotteries: a guidance for voluntary groups

## **Charity Regulators:**

England and Wales – The Charity Commission  
Harmsworth House,  
13-15 Bouverie Street,  
London EC4Y 8DP  
0870 333 0123

Scotland – The Scottish Charities Office  
25 Chambers Street,  
Edinburgh EH1 1LA  
0131 226 2626

Northern Ireland – Charities Branch  
The Department for Social Development  
Churchill House,  
Belfast BT1 4SD  
028 90569314

### **EXAMPLE ENGAGEMENT LETTER FOR AN UNINCORPORATED CHARITY AUDIT (ENGLAND & WALES) (ACCRUALS BASIS FOR ACCOUNTS PREPARATION)**

The Trustees  
Charity

Dear Sirs

1 The purpose of this letter is to set out the basis on which we [are to] act as auditors of the charity and the respective areas of responsibility of the Trustees and of ourselves.

#### **Audit**

2 As trustees of the (above charity) you are responsible for ensuring that the charity maintains appropriate accounting records and for preparing financial statements which give a true and fair view and have been prepared in accordance with the Charities Act 1993 and regulations thereunder. You are also responsible for making available to us, as and when required, all of the charity's accounting records and all other relevant records and related information, including minutes of trustees' meetings and of all appropriate management meetings.

3 As trustees of a charity, you are under a duty to prepare an annual report for each financial year complying in its form and content with regulations made under the Charities Act 1993. You should also have regard to the Statement of Recommended Practice 'Accounting and Reporting by Charities', issued in October 2000 by the Charity Commissioners for England & Wales.

4 We have a statutory responsibility to report to you as trustees whether in our opinion the financial statements comply with the requirements of regulations made under the Charities Act 1993 and give a true and fair view of the state of affairs of the charity at the end of the financial year and of the incoming resources and application of the resources of the charity in that year. In arriving at our opinion, we are required to consider the following matters, and report on any in respect of which we are not satisfied:

- 4.1 whether accounting records have been kept by the [charity] in accordance with Section 41 of the Charities Act 1993;
- 4.2 whether the financial statements are in agreement with the accounting records;
- 4.3 whether we have obtained all the information and explanations to which we are entitled for the purpose of our audit; and
- 4.4 whether the information in the trustees' statutory annual report is consistent with that in the financial statements.

5. In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in our report; for example, non-compliance with a requirement of Regulations made under the Charities Act 1993.

6. Under the Charities (Accounts and Reports) Regulations 2000 you are required to report as to whether you have given consideration to the major risks to which the charity is exposed, and to the systems designed to mitigate those risks. Compliance with the Charities SORP requires you to confirm that those risks have been reviewed and that systems have been established to mitigate those risks. We are not required to audit this statement, or to form an opinion on the effectiveness of the risk management and control procedures.

7. We have a statutory duty to report to the Charity Commissioners such matters (concerning the activities or affairs of the charity or any connected institution or body corporate) of which we become aware during the course of our audit which are (or are likely to be) of material significance to the Commissioners in the exercise of their powers of inquiry into, or acting for the protection of, charities (Regulation 6(5) The Charities (Accounts and Reports) Regulations 1995).

7. We have a professional responsibility to report if the financial statements do not comply in any material respect with applicable accounting standards, unless in our opinion the non-compliance is justified in the circumstances. In determining whether or not the departure is justified we consider:

8.1 whether the departure is required in order for the financial statements to give a true and fair view; and

8.2 whether adequate disclosure has been made concerning the departure.

9. Our professional responsibilities also include:

9.1 including in our report a description of the trustees' responsibilities for the financial statements where the financial statements or accompanying information do not include such a description; and

9.2 considering whether other information in documents containing audited financial statements is consistent with those financial statements.

### **Scope of audit**

10. Our audit will be conducted in accordance with the Auditing Standards issued by the Auditing Practices Board, and will include such tests of transactions and of the existence, ownership and valuation of assets and liabilities as we consider necessary. We shall obtain an understanding of the accounting systems and internal controls in order to assess their adequacy as a basis for the preparation of the financial statements, and to establish whether appropriate accounting records have been maintained by the charity. We shall expect to

obtain such relevant and reliable evidence as we consider sufficient to enable us to draw reasonable conclusions therefrom.

### ***Reporting to the Council and Management***

11. The nature and extent of our procedures will vary according to our assessment of the charity's accounting system and, where we wish to place reliance on it, the internal control system, and may cover any aspect of the charity's operations that we consider appropriate. Our audit is not designed to identify all significant weaknesses in the charity's systems but, if such weaknesses come to our notice during the course of our audit which we think should be brought to your attention, we shall report them to you. Any such report may not be provided to third parties without our prior written consent. Such consent will be granted only on the basis that such reports are not prepared with the interests of anyone other than the charity in mind and that we accept no duty or responsibility to any other party as concerns the reports.

### ***Representations by management/trustees***

12. As part of our normal audit procedures, we may request written confirmation of oral representations which we have received during the course of the audit on matters having a material effect on the financial statements.

### ***Documents issued with the financial statements***

13. In order to assist us with the examination of your financial statements, we shall request sight of all documents or statements, including the trustees' report, which are due to be issued with the financial statements. If it is proposed that any documents or statement which refer to our name, other than the audited financial statements, are to be circulated to third parties, please consult us before they are issued.

### ***Irregularities, including fraud***

14. The responsibility for the prevention and detection of fraud, error and non-compliance with law or regulations rests with yourselves. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or accounting records (including those resulting from fraud, error or non-compliance with law or regulations), but our examination should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist.

### ***Other matters***

15. (Where appropriate) We shall not be treated as having notice, for the purposes of our audit responsibilities, of information provided to members of our firm other than those engaged on the audit (for example, information provided in connection with accounting, taxation and other services).

16. Once we have issued our report we have no further direct responsibility in relation to the financial statements for that financial year. However, we expect that you will inform us of any material event occurring between the date of our report and that of the Annual General Meeting which may affect the financial statements.

**Other services**

17. You have requested that we provide other services in respect of ..... . The terms under which we provide these other services are dealt with in a separate letter. We will also agree in a separate letter of engagement the provision of any services relating to investment business advice as defined by the Financial Services and Markets Act 2000.

**Fees**

18. Our fees are computed on the basis of the time spent on your affairs by the partners and our staff, and on the levels of skill and responsibility involved. Unless otherwise agreed, our fees will be billed at appropriate intervals during the course of the year and will be due on presentation.

**Applicable law**

19. This engagement letter shall be governed by, and construed in accordance with, [English] law. The Courts of [England] shall have exclusive jurisdiction in relation to any claim, dispute or difference concerning the engagement letter and any matter arising from it. Each party irrevocably waives any right it may have to object to an action being brought in those Courts, to claim that the action has been brought in an inconvenient forum, or to claim that those Courts do not have jurisdiction.

**Agreement of terms**

20. Once it has been agreed, this letter will remain effective from one audit appointment to another until it is replaced. We should be grateful if you would confirm in writing your agreement to these terms, [either by acknowledging it or] by signing and returning the enclosed copy of this letter, or let us know if they are not in accordance with your understanding of our terms of engagement.

Yours faithfully

.....

Auditors

We agree to the terms of this letter.

.....

Signed, for and on behalf of Charity      Date

.....

Position

***Alternative paragraphs for an unincorporated charity in England & Wales which prepares accounts on a receipts and payments basis***

1    *Para 3:* In accordance with the Charities Act 1993 Section 42(3), where the charity’s gross income in any financial year does not exceed £100,000, the charity’s trustees may elect to prepare a receipts and payments account and a statement of assets and liabilities [as its annual statement of accounts]. [You have elected to prepare such an account and statement.]

2    References in paragraphs 4, 9, 10 and 12 of the letter will be to the ‘account and

statement' rather than to 'statement of account/financial statement'.

3 The reference in paragraph 4 to the consistency of the trustees' annual report to the financial statements will be dropped.

4 The statutory requirement for the auditor to report if the financial statements do not comply with applicable accounting standards does not apply, so paragraph 8 is dropped.

***Alternative paragraphs where the charity is incorporated under the Companies Act 1985***

1 Para 1: The first paragraph can refer to 'charitable company' rather than 'charity', and the first reference to 'Trustees' is followed in brackets by the words 'being company directors'. The numbered paragraphs are changed as follows:

2 *Para 2:* As directors of the above charitable company, you are responsible for ensuring that the company maintains proper accounting records and for preparing financial statements which give a true and fair view and have been prepared in accordance with the Companies Act 1985 [in the case of charities incorporated under other legislation, the reference will be to the applicable legislation]. You are responsible for making available to us, as and when required, all the company's accounting records and all other relevant records and related information, including minutes of meetings of members, trustees and management.

3 *Para 3:* The reference in paragraph 3 is to 'charitable company' rather than charity, but the obligations to prepare an annual report complying in the form and content with the Charities 2000 Regulations are the same. The accounts of all charitable companies and audit reports which are annexed to the annual report are prepared in accordance with the Companies Act 1985.

4 *Para 4:* We have a statutory responsibility to report to the members whether in our opinion the financial statements give a true and fair view and whether they have been properly prepared in accordance with the Companies Act 1985. In arriving at our opinion, we are required to consider the following matters, and to report on any in respect of which we are not satisfied:

- 4.1 whether proper accounting records have been kept by the company and proper returns adequate for our audit have been received from branches not visited by us;
- 4.2 whether the company's balance sheet and income and expenditure account are in agreement with the accounting records and returns;
- 4.3 whether we have obtained all the information and explanations which we consider necessary for the purposes of our audit; and
- 4.4 whether the information given in the trustees' annual report (directors' report) is consistent with the financial statements.

5 *Para 7:* In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in our report. For example, where the financial statements do not give details of directors' remuneration or their other transactions with the company, the Companies Act 1985 requires us to disclose such matters in our report.

*There is no statutory duty for auditors of charitable companies to report to the Charity Commissioners. However auditors may wish to refer to the possibility that circumstances may arise that will cause them to report to an appropriate authority in the public interest.*

6. *Paras 10 to 16:* These paragraphs on the scope of the audit are replaced by the wording in paragraphs 2.1 to 2.7 from the example engagement letter in the appendix to SAS 140.

***Alternative paragraphs where the charity is unincorporated and based in Scotland.***

1. References in paragraphs 2, 3 4 and 5 will be to the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 instead of the Charities Act 1993.

2. Reference in paragraph 4 will read "and of the incoming resources and application of resources, including the income and expenditure, of the charity in that year " in place of "and of the incoming resources and application of the resources of the charity in that year."

3. Reference in paragraph 4.1 will be to Section 4 of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 instead of Section 41 of the Charities Act 1993.

4. A Duty to report to the Charity Commissioners included in Paragraph 7 does not exist for Scottish "recognised" charities. In place of this section there should be reference to the fact that "As auditors we have a right to report to the appropriate authorities on matters of mismanagement or fraud exposed during the course of the audit which we consider are material and impact on the public interest."

5. Reference in paragraph 19 to Scottish Law and the Courts of Scotland instead of English and England.

### EXAMPLE REPRESENTATION LETTER

To:

[Auditors]

Dear Sirs

We confirm to the best of our knowledge and belief, and having made appropriate enquiries of other trustees/directors and officials of the charity, the following representations given to you in connection with your audit of the charity's financial statements for the year ended ... .

#### General

1 We acknowledge as directors our responsibility under the Companies Act 1985 [Charities Act 1993<sup>42</sup> (unincorporated charity)] for the financial statements which give a true and fair view and for making accurate representations to you. All the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the charity have been properly reflected and recorded in the accounting records. All other records and related information, including minutes of trustees, members and management meetings, have been made available to you.

#### Going concern

2 We believe that it is appropriate for the charity's financial statements to have been prepared on a going concern basis on the grounds that current and future sources of funding or support will be more than adequate for the charity's needs. We believe that no further disclosures relating to the charity's ability to continue as a going concern need to be made in the financial statements.

#### Law and regulations

3 We are not aware of any irregularities, including fraud, involving management or employees of the charity; nor are we aware of any breaches or possible breaches of statute, regulations, contracts, [or] agreements [or the company's Memorandum and Articles of Association (charitable company)] [which might prejudice the charity's going concern status or that might result in the charity suffering significant penalties or other loss]. No allegations of such irregularities, including fraud, or such breaches have come to our notice.

#### Loans and arrangements

4 The charity has not had nor entered into at any time during the year, any arrangement, transaction or agreement to provide credit facilities (including loans, quasi-loans or credit facilities) for directors nor to guarantee or provide security for such matters [charitable company].

### **Transactions with related parties**

5 We are not aware of any transactions with related parties requiring disclosure in the financial statements. Or: All transactions with related parties have been disclosed in the financial statements. We have made available to you all relevant information concerning such transactions and are not aware of any other matters which require disclosure.

### **Post-balance sheet events**

There have been no events since the balance sheet date which necessitate revision of the figures included in the financial statements or inclusion of a note thereto. Should further material events occur, which may necessitate revision of the figures included in the financial statements or inclusion of a note thereto, we will advise you accordingly.

### **Grants and donations**

7 All grants, donations and other incoming resources, the receipt of which is subject to specific terms or conditions, have been notified to you. There have been no breaches of terms or conditions in the application of such incoming resources. Restricted grants and donations are as follows/listed overleaf:

Yours faithfully

.....  
Signed on behalf of the board of directors/trustees                      Date

### ***Examples of other matters where confirmation of representations may be necessary***

- Material accounting estimates - confirming basis of estimation
- Lack of evidence - material representations where no other evidence available
- Trustees/directors opinions - confirmations of opinions concerning e.g. the principles applied to the recognition of legacy income during the period
- Provisions for doubtful debts
- Contentious legal matters
- Accounting policies - confirming appropriately adopted and disclosed
- Bank or loan facilities - confirming no breaches of covenant or terms.

### **ILLUSTRATIVE EXAMPLES OF AUDITORS' REPORTS ON CHARITIES' FINANCIAL STATEMENTS**

- 1 Unqualified opinion: charity incorporated under the Companies Act as a company limited by guarantee in Great Britain or Northern Ireland
- 2 Unqualified opinion: unincorporated charity in England and Wales preparing financial statements under section 42(1) of the Charities Act 1993
- 3 Unqualified opinion: unincorporated charity in England and Wales preparing a receipts and payments account and statement of assets under section 42(3) of the Charities Act 1993
- 4 Unqualified opinion: unincorporated charity in Scotland
- 5 The auditors' statement on summarised financial statements

*(Examples of qualified auditors' reports are set out in SAS 600).*

#### **Example 1: Unqualified opinion: charity incorporated under the Companies Act as a company limited by guarantee in Great Britain or Northern Ireland**

##### **Independent Auditors' Report to the members of XYZ Charity Ltd.**

We have audited the financial statements of (name of charity) for the year ended ... which comprise (state primary financial statements such as the Statement of Financial Activities, Summary Income and Expenditure Account, the Balance Sheet, the Cash Flow Statement) and related notes<sup>43</sup>. These financial statements have been prepared under the historical cost convention [as modified by the revaluation of certain fixed assets] and the accounting policies set out therein.

##### **Respective responsibilities of trustees and auditors**

The trustees' (who are also the directors of XYZ Charity Ltd for the purposes of company law) responsibilities for preparing the Trustees' Annual Report<sup>44</sup> and the financial statements in accordance with applicable law and United Kingdom Accounting Standards are set out in the Statement of Trustees' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

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<sup>43</sup> Auditors' reports of entities that do not publish their financial statements on a web site or publish them using 'PDF' format may continue to refer to the financial statements by reference to page numbers.

<sup>44</sup> In some cases this may be referred to as the Directors' Report.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the (Companies Act 1985) (Companies (Northern Ireland) Order 1986). We also report to you if, in our opinion, the Trustees' Annual Report is not consistent with the financial statements, if the charity has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding trustees' remuneration and transactions with the charity is not disclosed.

We read other information contained in the Trustees' Annual Report<sup>45</sup>, and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### **Basis of audit opinion**

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the trustees in the preparation of the financial statements, and of whether the accounting policies are appropriate to the charity's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### **Opinion**

In our opinion the financial statements give a true and fair view of the state of the charity's affairs as at 31 December 20.. and of its incoming resources and application of resources, including its income and expenditure, for the year then ended and have been properly prepared in accordance with the (Companies Act 1985) (Companies (Northern Ireland) Order 1986.)

*Registered auditors*

*Address*

*Date*

## **Example 2: Unqualified opinion: unincorporated charity in England and Wales preparing financial statements under section 42(1) of the Charities Act 1993**

### **Independent Auditors' Report to the trustees of XYZ charity**

We have audited the financial statements of (name of charity) for the year ended .... which comprise (state primary financial statements such as the Statement of Financial Activities, the

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45 Use the title of the document issued by the charity containing the audited financial statements.

Balance Sheet, the Cash Flow Statement) and the related notes<sup>46</sup>. These financial statements have been prepared under the historical cost convention [as modified by the revaluation of certain fixed assets] and the accounting policies set out therein.

### **Respective responsibilities of trustees and auditors**

The trustees' responsibilities for preparing the Trustees' Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards are set out in the Statement of Trustees' Responsibilities.

We have been appointed as auditors under section 43 of the Charities Act 1993 and report in accordance with regulations made under section 44 of that Act. Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Charities Act 1993. We also report to you if, in our opinion, the Trustees' Annual Report is not consistent with the financial statements, if the charity has not kept proper accounting records, or if we have not received all the information and explanations we require for our audit.

We read other information contained in the Trustees' Annual Report<sup>47</sup>, and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### **Basis of audit opinion**

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the trustees in the preparation of the financial statements, and of whether the accounting policies are appropriate to the charity's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming an opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

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<sup>46</sup> Auditors' reports of entities that do not publish their financial statements on a web site or publish them using 'PDF' format may continue to refer to the financial statements by reference to page numbers.

<sup>47</sup> Use the title of the document issued by the charity containing the audited financial statements.

## **Opinion**

In our opinion the financial statements give a true and fair view of the state of the charity's (and its subsidiaries') affairs as at 31 December 20.. and of its (their) incoming resources and application of resources in the year then ended and have been properly prepared in accordance with the Charities Act 1993.

*Registered auditors*

*Address*

*Date*

### **Example 3: Unqualified opinion: unincorporated charity in England and Wales preparing a receipts and payments account and statement of assets under section 42(3) of the Charities Act 1993**

#### **Independent Auditors' Report to the trustees of XYZ charity**

We have audited the receipts and payments account and statement of assets and liabilities of (name of charity) for the year ended.... , and the related notes.

#### **Respective responsibilities of trustees and auditors**

The trustees' responsibilities for preparing the account and statement in accordance with applicable law and United Kingdom Accounting Standards are set out in the Statement of Trustees' Responsibilities. The account and statement have been prepared under section 42(3) of the Charities Act 1993 following the guidance for accounting under the receipts and payments basis issued by the Charity Commission<sup>48</sup>.

We have been appointed as auditors under section 43 of the Charities Act 1993 and report in accordance with regulations made under section 44 of that Act. Our responsibility is to audit the account and statement in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the account and statement are properly presented and prepared in accordance with the Charities Act 1993. We also report to you if, in our opinion, the charity has not kept proper accounting records, or if we have not received all the information and explanations we require for our audit.

#### **Basis of audit opinion**

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the account and statement.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the

overall adequacy of the presentation of information in the account and statement, including whether any material special trust or other restricted fund is adequately distinguished<sup>49</sup>.

## **Opinion**

In our opinion the account and statement properly present the receipts and payments of the charity for the year ended 31 December 20.. together with its statement of assets and liabilities as at that date and have been properly prepared in accordance with the provisions of the Charities Act 1993 applicable to smaller charities.

*Registered auditors*

*Address*

*Date*

## **Example 4: Unqualified opinion: unincorporated charity in Scotland**

### **Independent Auditors' Report to the trustees of XYZ charity**

We have audited the financial statements of (name of charity) for the year ended ...which comprise (state primary financial statements such as the Income and Expenditure Account, the Statement of Financial Activities (if presented as a separate primary statement), the Balance Sheet, the Cash Flow Statement) and the related notes<sup>50</sup>. These financial statements have been prepared under the historical cost convention [as modified by the revaluation of certain fixed assets] and the accounting policies set out therein.

### **Respective responsibilities of trustees and auditors**

The Trustees' responsibilities for preparing the Trustees' Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards are set out in the Statement of Trustees' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990, the Charities Accounts (Scotland) Regulations 1992, and/or the terms of the charity's founding deed. We also report to you if, in our opinion, the Trustees' Report is not consistent with the financial statements, if the charity has not kept proper accounting records, or if we have not received all the information and explanations we require for our audit.

We read other information contained in the Trustees' Annual Report<sup>51</sup> and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the

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49 Reference to special trusts is a specific requirement of the Regulations for reports on the account and statement.

50 Auditors' reports of entities that do not publish their financial statements on a web site or publish them using 'PDF' format may continue to refer to the financial statements by reference to page numbers.

51 Use the title of the document issued by the charity containing the audited financial statements.

financial statements. Our responsibilities do not extend to any other information.

### **Basis of audit opinion**

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the trustees in the preparation of the financial statements, and of whether the accounting policies are appropriate to the charity's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### **Opinion**

In our opinion the financial statements give a true and fair view of the state of the charity's affairs as at 31 December 20.. and of its incoming resources and application of resources including, in its income and expenditure account, the surplus or deficit for the year then ended and have been properly prepared in accordance with the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990, the Charities Accounts (Scotland) Regulations 1992 and/or the terms of the charity's founding deed.

*Registered auditors*

*Address*

*Date*

### **Example 5: The auditors' statement on summarised financial statements**

#### **Independent Auditors' statement to the Trustees of XYZ charity**

We have examined the summarised financial statements of (name of charity).

#### **Respective responsibilities of trustees and auditors**

The trustees are responsible for preparing the (summarised financial statements) in accordance with the recommendations of the charities SORP.

Our responsibility is to report to you our opinion on the consistency of the summarised financial statements with the full financial statements and Trustees' Annual Report. We also read the other information contained in the (summarised annual report) and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the summarised financial statements.

#### **Basis of opinion**

We conducted our work in accordance with Bulletin 1999/6 'The auditors' statement on the

summary financial statement' issued by the Auditing Practices Board for use in the United Kingdom.

**Opinion**

In our opinion the summarised financial statements are consistent [are not consistent] with the full financial statements and the Trustees' Annual Report of XYZ charity for the year ended 31 December 20xx (in the following respects....).

*Registered auditors*

*Address*

*Date*

### EXAMPLE STATEMENTS OF TRUSTEES' RESPONSIBILITIES

The general duties of trustees in relation to financial reporting are set out in Appendix 1, but these need to be adapted to the circumstances of individual entities. Examples are given below of statements for:

1. a trust which is subject only to the regulation generally applicable to charities in the country where it is based (England & Wales, or Scotland, or Northern Ireland);
2. a charitable company which is subject to the requirements of the Companies Act 1985 (this example illustrates wording appropriate to consolidated accounts).

#### **1 Statement of trustees' responsibilities - charitable trust**

Law applicable to charities in England & Wales/Scotland/Northern Ireland requires the trustees to prepare financial statements for each financial year which give a true and fair view of the charity's financial activities during the year and of its financial position at the end of the year. In preparing financial statements giving a true and fair view, the trustees should follow best practice and:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether applicable accounting standards and statements of recommended practice have been followed, subject to any departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the charity will continue in operation.

The trustees are responsible for keeping accounting records which disclose with reasonable accuracy the financial position of the charity and which enable them to ascertain the financial position of the charity and which enable them to ensure that the financial statements comply with (*applicable law, regulations and trust deed*). They are also responsible for safeguarding the assets of the charity and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

#### **2 Statement of trustees' responsibilities - charitable company preparing group accounts**

The trustees are required to prepare financial statements for each financial year, which give a true and fair view of the state of affairs of the charity and the group and the incoming resources and application of resources, including the net income or expenditure, of the group for the year. In preparing those financial statements, the trustees are required to:

- select suitable accounting policies and then apply them consistently;

- make judgments and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going-concern basis unless it is inappropriate to presume that the charity will continue in business.

The trustees are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the charity and the group and which enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the charity and the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

### **INDEPENDENT EXAMINATION: COMPARISON WITH AUDIT**

#### **Introduction**

1 Registered auditors may be engaged to carry out the independent examination of the accounts of a charity based in England & Wales or Scotland. Guidance on the procedures to be followed in respect of charities in England & Wales has been prepared by the Charity Commission in respect of independent examination under the 1993 Charities Act. This Appendix compares the procedures for independent examination set out in the Charity Commission guidance notes with the requirements of Auditing Standards.

#### **Level of assurance given**

2 The level of assurance given by the independent examiner's report is lower than that provided by an audit undertaken under SASs. The Scottish Regulations require the independent examiner to state whether, according to the best of his knowledge and belief and in accordance with the information and explanations given to him, the financial statements have been properly prepared and comply with the terms of the 1992 Regulations (Scotland) and the body's governing document. For England & Wales, the independent examiner's reporting requirements are set out in the Regulations (E&W). The report is made in terms of whether or not matters have come to light which give reasonable cause to believe that the specific requirements have not been met. The examiner considers when reporting whether the accounts are in agreement with the underlying accounting records and whether the accounts and records comply with the relevant legislation. A statement is also required as to whether or not any matter has been identified, in connection with the examination, to which attention should be drawn to enable a proper understanding of the accounts to be reached. Under the 1993 Act the Charity Commissioners have issued Directions which provide the procedural framework under which such an examination is undertaken.

3 The main thrust of the Directions given by the Charity Commission under subsection (7)(b) of section 43 of the Charities Act is that the independent examiner is not required to build up a body of evidence to support a positive statement of opinion on a charity's accounts. Instead, the examiner reports, based on the examination carried out, whether or not specific matters have come to his or her attention. The assurance provided is effectively a negative assurance based on the procedures required by the Directions.

4 In addition, other specific matters are reported on an exception basis where they have become apparent. Material expenditure or action contrary to the trusts of a charity, failure to be provided with necessary information or explanations, or where a material inconsistency between the statement of accounts and the trustees' annual report is identified in the course of the procedures required by the Directors all give rise to exception reporting.

#### **Reporting to trustees**

5 Appendices to the guidance notes issued by the Charity Commission contain details of

examiners' reporting duties under the relevant regulations and examples of examiners' reports.

### Reporting to third parties

6 The section on SAS 620 in this Practice Note provides guidance on the auditors' duty to inform the Charity Commissioners of matters of significance. The independent examiner of a charity established in England & Wales has a statutory duty to inform the Charity Commissioners in writing if, whilst acting in the capacity of the examiner of a charity, information or evidence is obtained which gives the examiner reasonable cause to believe that any one or more of the charity trustees has been responsible for deliberate or reckless misconduct in the administration of the charity. There is no equivalent duty in Scotland.

### Differences between audit and independent examination

7 Where, in the course of an independent examination of a charity's accounts, it becomes apparent that the gross income or total expenditure has exceeded the limits above which a full audit is required, the independent examiner will need to notify the trustees of this discovery. Provided that the independent examiner is a registered auditor, a new engagement is agreed with the charity whereby an audit is undertaken by the practitioner.

8 The following table sets out the principal differences between audit and independent examination of charity accounts.

### COMPARISON OF AUDIT TO INDEPENDENT EXAMINATION UNDER THE REGULATIONS (UNINCORPORATED CHARITIES ESTABLISHED IN ENGLAND & WALES)

| Procedure/principle  | Audit          | Independent Examination |
|--|----------------|-------------------------|
| Opinion required as to whether accounts show a true and fair view  | Yes            | No                      |
| Level of assurance given   | High, positive | Moderate, negative      |
| Check accounting records to establish entitlement to independent examination instead of audit  | N/A            | Yes                     |
| Obtain understanding of the charity's constitution, organisation, accounting systems, activities and nature of its assets, liabilities, incoming resources and application | Yes            | Yes                     |

of resources in order to plan appropriate procedures

Record the procedures carried out and document matters which are important to support conclusions reached or statements provided in the report

Yes

Yes

Consideration of accounting records

Carry out procedures to enable formation of *opinion* as to whether in accordance with statutory requirements

Review with a view to identifying *major* failure to maintain accounting records in accordance with s.41 Charities Act 1993

Analytical review

Yes

Yes

Substantive testing e.g. vouching source, physical inspection of fixed assets, obtaining bank confirmation of investment certificates etc.

Yes

No - unless the analytical review shows unusual documents, items for which the trustees cannot give satisfactory explanations

Review financial statements for conformity with applicable rules on form and content

Yes

Yes

Consider conformity with fundamental accounting concepts e.g. going concern  
Consider any significant estimate or judgment made in preparing the accounts

Yes

Yes - in case of accruals-based accounts policies adopted by charity should conform to fundamental accounting concepts and be appropriate to activities of the charity

Post-balance sheet events

Obtain sufficient appropriate evidence

Enquiry of trustees (accruals based accounts)

|   |     |                               |
|---|-----|-------------------------------|
| Identify and report on any major inconsistencies between any financial references in the Trustees' report (if any) and financial statements | Yes | Yes - accruals based accounts |
| Obtain all information and explanations needed for purpose of assignment - report any failure   | Yes | Yes                           |

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## Appendix 8

### **EXAMPLES OF MATTERS THAT WOULD BE ROUTINELY INVESTIGATED BY THE CHARITY COMMISSION**

Regulation 6(5) of the 1995 Regulations (E&W) requires auditors of unincorporated registered charities in England and Wales to report direct to the Charity Commission circumstances that

“...the auditor has reasonable cause to believe that is, or is likely to be, of material significance for the exercise, in relation to the charity of the Commission’s functions under section 8 (general powers to institute inquiries) or 18 (power to act for protection of charities) of the 1993 Act.”

This Appendix should be read in conjunction with the guidance provided in this Practice Note on the application of SAS 620. Regulation 6(5) does not require auditors to perform any additional audit work as a result of the statutory duty nor are auditors required specifically to seek out reportable matters. Auditors do however include procedures within their planning processes to ensure that members of the audit team have sufficient understanding (in the context of their role) to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator.

In order to recognise whether a situation is likely to be of material significance to a regulator’s function an understanding is needed of those matters which either due to their nature or potential financial impact are likely to require investigation by the regulator. The SAS 620 section of this Practice Note provides general guidance on the interpretation of “material significance” in the context of the Charity Commission functions. This Appendix provides illustrative examples of matters that where identified would routinely be evaluated and where appropriate investigated by the Charity Commission.

The examples provided are of an illustrative nature and are provided solely to assist auditors in making a decision as to whether a matter identified is or is likely to be of material significance to the regulator.

#### **Matters which will always be investigated by the Charity Commission**

Matters falling within this category are considered central to the integrity of a charity and as such would always require evaluation and where appropriate investigation by the Charity Commission. Such matters may suggest dishonesty on the part of any charity trustee or member of the charity’s senior management or involve a significant misapplication of funds for a non-charitable purpose, including transactions giving rise to unauthorised benefits or other remuneration to charity trustees (or person connected with a trustee). These, where identified by the auditors, create the highest presumption of reportability.

(a) Matters suggesting dishonesty or misuse of charitable funds. Indicative examples include:

- evidence of false accounting, theft or misappropriation of assets by any charity trustee or member of the charity's senior management;
- evidence that gives reasonable cause to doubt the honesty or integrity of a charity trustee or the trustee body;
- evidence of a significant misapplication of charitable funds for a non-charitable purpose;
- evidence that any charity trustee is a person disqualified from acting as a charity trustee under section 72 of the 1993 Act and not having obtained a waiver from disqualification (disqualification may arise from a conviction involving dishonesty or deception, undischarged bankruptcy, sequestration, a composition or arrangement with creditors, a disqualification or removal order);
- evidence of a charity trustee, employee or agent knowingly or recklessly providing the Charity Commission with information which is false or misleading in a material respect (Section 11 of the 1993 Act).

(b) A serious breach of a legislative requirement or of the charity's trusts. Indicative examples include:

- receipt by any charity trustee ( or person connected with a trustee) of remuneration or significant other benefits from the assets of the charity without proper powers or consents;
- a charity entering into a significant transaction with a charity trustee (or person connected with a charity trustee) without proper authority which give rise to a conflict of interest or may be to the benefit of the trustee or connected person;
- a significant ex-gratia payment or waiver of entitlement given to any person connected with the charity without proper authority under Section 27 of the 1993 Act;
- a significant inaccuracy in the completion of an annual return made under Section 48 of the 1993 Act which is not immediately corrected on identification;
- a significant breach of an order made under the 1993 Act prohibiting a particular transaction or granting consent on particular terms.

### **Matters that are very likely to be investigated by the Charity Commission**

Matters falling within this category are likely to be indicative of significant risks to charitable funds or their proper application and would therefore normally be evaluated and where appropriate investigated by the Charity Commission. Such matters, where identified, therefore create a strong presumption as to reportability. The Charity Commission would expect auditors to be able to document and justify the basis of any decision not to report a matter falling within this category.

All such matters which are judged by the auditor not to be a matter of material significance are nevertheless likely to be matters that need to be drawn to the attention of charity trustees by a

report under SAS 610.

Where a matter, which was judged not to be reportable, arises again in the subsequent accounting period then a reoccurrence of the matter will require particular consideration by the auditors. A matter falling within this category and identified in a report to the trustees and management under SAS 610 in the previous period that has not been addressed and remedied or reoccurs in the subsequent accounting period should be regarded as reportable.

(a) Serious deficiencies in the arrangements made by the charity trustees in relation to the management and control of charitable funds. Indicative examples include:

- evidence that the trustee body as a whole have failed to exercise proper control over the administration and management of the charity's affairs and activities, having due regard to the nature of its trusts and activities;
- evidence of recklessness on the part of the trustee body as a whole giving rise to a significant risk of a material loss or misapplication of charitable funds;
- adequate arrangements have not been made by the charity trustees to monitor functions delegated to third parties;
- uncertainty exists as to who are the charity trustees;
- a lack of adequate security or control over the assets of the charity;
- the auditors have been prevented from continuing with or completing the audit as a result of insufficient records being available or insufficient explanations being given in answer to questions raised;
- a breach of the duty to keep accounting records, as required by section 41 of the 1993 Act, which is so material or pervasive that the auditors are unable to express an opinion on the financial statements.

(b) A significant breach of a legislative requirement or of the charity's trusts. Indicative examples include:

- a significant breach of law or regulation, not specific to a charity, that could prevent the charity from undertaking a significant part of its activities e.g. loss of registration in a residential care charity;
- a significant ex-gratia payment or waiver of entitlement given to any third party unconnected with the charity without proper authority under Section 27 of the 1993 Act;
- a significant breach of the law relating to fund raising undertaken by professional fundraisers or commercial participators. In particular, a failure to make the required statement as to the method of remuneration, the failure to pay all cash and cheques so raised to the charity gross, and a failure to enter into a proper agreement with the charity [Part II of the Charities Act 1992 (ss. 58 to 64 as amended) and the Charitable Institutions

(Fund-Raising) Regulations 1994];

- a significant investment made recklessly and contrary to the proper advice and investment criteria requirements of the Trustee Act 2000;
- evidence of a significant application of funds for purposes, whilst charitable, that are outside the charity's objectives or contrary to any special trust;
- the auditors being obstructed by the action or inaction of any charity trustee from obtaining all information or explanations necessary for the purposes of the statutory audit (Regulation 8 of the 1995 Regulations (E&W));
- failure by the charity trustees to seek registration with the Charity Commission of an entity purporting to be charitable (other than a special trust of an existing registered charity) that would, if charitable, be registerable under Section 3 of the 1993 Act.

(c) Matters suggesting dishonesty (that does not involve a charity trustee or senior management of the charity) or misapplication of the charity's funds. Indicative examples include:

- evidence existing of any significant theft or misappropriation by any charity employee (other than a member of the charity's senior management), volunteer, agent or third party and this matter has not been reported to the Police Authorities or the Charity Commission;
- knowingly making significantly inaccurate or misleading claims in relation to the charity or its activities in its publicity or fundraising material.

### **Matters that may give rise to an investigation by the Charity Commission**

In considering a matter arising identified as falling within this category, the auditors will also consider whether the matter arising is an isolated incident or of a recurring nature or pattern. Where the matter reoccurs or several separate matters arise within this category then the likelihood that the Charity Commission would investigate will be greater due to the pervasive nature of such instances. The auditors will also need to consider the cumulative impact of such matters.

Matters falling within this category are often capable of remedy with the co-operation of the trustee body. Where such issues have been identified and remedied by the Trustees and the auditors are satisfied that there is no ongoing risk to the proper application of charitable funds then a duty to report is unlikely to arise.

Where a matter is identified which is judged not to be a matter of material significance the auditors are likely to report such matters in reports to trustees and management under SAS610.

Indicative examples of matters that may give rise to an investigation by the Charity Commission relating to breaches of a legislative requirement or of the charity's trusts include:

- evidence existing of a failure to make a required return to the relevant UK tax authorities for any significant liability to any direct or indirect tax;
- a failure to obtain Inland Revenue agreement for any significant non-qualifying loan or investment ( Schedule 20 of ICTA 1988);
- a failure, without first obtaining official consent, to obtain and consider proper advice prior to the mortgaging of charity land as required by Section 38 of the 1993 Act;
- a charity undertaking a significant non-charitable trade falling outside current taxation exemptions or extra-statutory concessions available to charities.

### **Ceasing to hold office**

In addition to the duty to report matters of material significance, Regulation 6(6) of the 1995 Regulations (E&W) provides that 'Where an auditor appointed by charity trustee ceases for any reason to hold office he shall send to the charity trustees a statement of any circumstances connected with his ceasing to hold office which he considers should be brought to their attention or, if he considers that there are no such circumstances, a statement that there are none; and the auditor shall send a copy of any statement sent to the charity trustees under this paragraph (except a statement that there are no such circumstances) to the Commission.

Matters that may require consideration in relation to this duty include:

- disagreement over opinions expressed or to be expressed in an auditors' report;
- disagreement over any disclosure made or to be made to the Commission in respect of a matter of material significance;
- disagreement over any accounting policy, assumption, financial judgment or disclosure made in the accounts or in the preparation of the accounts;
- concerns over any matter which is believed to give rise to a material risk of a loss of charitable funds; and
- lack of co-operation or obstruction in the context of an audit.

### DEFINITIONS

Abbreviations and frequently used terms in this Practice Note are set out below:

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|                               |   |
|-------------------------------|---|
| <i>Branches</i>               | <p>Entities or administrative bodies set up, for example, to conduct a particular aspect of the business of the charity, or to conduct the business of the charity in a particular geographical area. They may or may not be legal entities which are separate from the charity. For the purpose of the Charities SORP a branch is:</p> <ul style="list-style-type: none"><li>• simply part of the administrative machinery of the charity, or</li><li>• a separate legal entity which is administered by or on behalf of the charity and whose funds are held for specific purposes which are within the general purposes of the charity. 'Legal entity' means a trust or unincorporated association or other body formed for a charitable purpose,</li><li>• in England and Wales, a separate legal entity not falling within the above which the Charity Commission has united by a direction under section 96(5) or 96(6), Charities Act 1993 should be treated as linked to the charity for accounting purposes.</li></ul> |
| <i>Charity</i>                | <p>Any institution, corporate or not, which is established for charitable purposes and is subject to the control of the High Court in the exercise of the Court's jurisdiction with respect to charities.</p>   |
| <i>Charitable purposes</i>    | <p>Purposes that are exclusively charitable according to the law of England and Wales.</p>  |
| <i>The Charity Commission</i> | <p>The regulatory body for charities in England and Wales, whose principal duties include :</p>   |

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- Maintaining a public Register of charities,
- Investigating misconduct and the abuse of charitable assets, and taking or recommending remedial action,
- Giving advice to charity trustees to make the administration of their charity more effective, and

Where necessary, making Schemes and Orders to enable the trustees to run their charities effectively by modernising the purposes and administrative machinery of charities and giving trustees additional powers.

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*Charitable company*

A company :

- Formed and registered under the Companies Act 1985, or
- To which the provisions of the 1985 Act apply as they apply to a company so formed and registered, and
- Which is established for exclusively charitable purposes.

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*Charity trustees*

The persons having the general control and management of the administration of a charity, regardless of what they are called.

For example, in the case of an unincorporated association the executive or management committee are its charity trustees, and in the case of a charitable company it is the directors who are the charity trustees.

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*Directors*

The SASs which are considered in sections of the Practice Note use the word 'directors' to describe the persons who are legally responsible for a reporting entity's affairs, including the preparation of its financial statements. The equivalent persons for a

charity are its trustees and the directors of a charitable company are, by virtue of their office, its trustees. The Practice Note therefore uses the term 'trustees' rather than 'directors'.

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*Excepted charity*

One which does not have to register with the Charity Commission, but in most other respects is fully within its jurisdiction. Under section 3(5) of the Charities Act 1993, the following charities fall into this category :

- Any charity which is excepted by an Order or by Regulations,
- Any charity which has neither
  - any permanent endowment, nor
  - the use or occupation of any land, and
  - whose annual income from all sources does not amount to more than £1000,
- Places of worship registered under the Places of Worship Registration Act 1855.

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*Exempt charities*

Exempt charities in England and Wales are specifically excluded from the Charity Commission's supervision and monitoring. Exempt charities do not register with the Charity Commission, nor do they submit accounts and annual returns. These are:

- Charities listed in Schedule 2 to the Charities Act 1993 (every institution listed is not necessarily a charity; the Act grants exempt status only " so far as they are charities"). The Schedule includes specifically named national museums, universities and medical schools, the Church Commissioners and charitable Friendly and Industrial and Provident Societies, and

- Any common investment fund (CIF) or common deposit fund (CDF) whose Scheme permits only exempt charities to participate, and
- Any other charities which legislation declares to be exempt. Examples of these include:
  - higher and further education corporations. These are now exempt charities by virtue of s.22A of the Further and Higher Education Act 1992 as inserted by s.41 of the Teaching and Higher Education Act 1998, and
  - the governing bodies of aided or controlled Voluntary or Foundation schools. These are exempt under s.23(1)(a) or (b) of the School Standards and Framework Act 1998. These schools are not in the independent schools sector but are voluntary aided or controlled schools within the state funded educational sector.

|                                      |  |
|--------------------------------------|--|
| <i>CA 85</i>                         | The Companies Act 1985.  |
| <i>The 1964 Act (NI)</i>             | The Charities Act (Northern Ireland) 1964  |
| <i>The 1987 Order (NI)</i>           | The Charities (Northern Ireland) Order 1987  |
| <i>1992 Act</i>                      | The Charities Act 1992, applicable to charities in England and Wales   |
| <i>1993 Act</i>                      | The Charities Act 1993, applicable to charities in England and Wales.  |
| <i>The Law Reform (MPS) Act 1990</i> | The Law Reform (Miscellaneous Provisions) (Scotland) Act 1990.   |
| <i>FSA</i>                           | The Financial Services Authority, the regulator for all businesses in the Financial Services industry, including Friendly Societies. |
| <i>The Charities SORP</i>            | Statement of Recommended practice - 'Accounting and Reporting by Charities', issued by the Charity Commission under the              |

auspices of the Accounting Standards Board in October 2000.

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*Gift Aid*

Tax relief for single outright cash gifts made to charity by individuals (including those carrying on a trade) and companies in the UK.

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*Management*

References in the Practice Note to 'management' are to those persons, who may include trustees, who have executive responsibility for the conduct of the entity's operation. Care needs to be taken to identify the legal position of senior staff. Many charities call their salaried chief executive 'Director' which is not to be confused with the term of Company Director in company law. In most cases, whilst accountable only to the trustee body and having responsibility for the execution of that body's policy, a salaried chief executive is not a trustee and therefore holds a position whose legal status is significantly different from that of a company director.

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*Non-departmental public body*

An entity that has a role in the process of government but is neither a government department nor forms part of a department. It is established at arm's length from departments and may carry out executive, regulatory, administrative or commercial functions.

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*The Regulations (E&W)*

The 1995 Regulations (E&W) mean The Charities (Accounts and Reports) Regulations 1995 for England and Wales; The 2000 Regulations (E&W) mean the Charities (Accounts and Reports) Regulations 2000 – collectively they are referred to as the Regulations (E&W).

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*Restricted funds*

Restricted funds are defined in Appendix 3 to the Charities SORP as

*'funds subject to specific trusts, which may be declared by the donor(s), or with their authority (eg in a public appeal), or created through legal process but still within the*

*wider objects of the charity. [They] may be restricted income funds, which are expendable at the discretion of the trustees in furtherance of some particular aspect(s) of the objects of the charity. Or they may be capital (ie endowment) funds, where the assets are required to be invested, or retained for actual use, rather than expended.'*

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SoFA

A Statement of Financial Activities. A charity's SoFA shows all the incoming resources becoming available during the year and all its expenditure for the year, and reconciles all the changes in its funds. The SoFA should account for all the funds of the charity and should be presented in columns representing the different types of funds.

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*Unincorporated charities*

Unincorporated charities means charities other than those which are formed and registered under the Companies Act 1985 or to which the provisions of that Act apply. The term includes charities incorporated by Royal Charter or by special Act of Parliament. Charities incorporated under general legislation other than the Companies Act, such as Industrial and Provident Societies Acts, are referred to separately as appropriate.

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## Appendix 10

### SOME SIGNIFICANT TOPICS RELEVANT TO AUDITS OF CHARITIES

| TOPIC                                | PARAGRAPH NUMBERS         | SECTION      |
|--------------------------------------|---------------------------|--------------|
| Branches                             | 22, 32 - 33               | Introduction |
|                                      | 42                        | SAS 110      |
|                                      | 99                        | SAS 200      |
|                                      | 108 – 112                 | SAS 210      |
|                                      | 117                       | SAS 220      |
|                                      | 136                       | SAS 300      |
|                                      | 143                       | SAS 400      |
|                                      | 177                       | SAS 510      |
| Charity Governing Documents          | 11 – 14, 16 – 17          | Introduction |
|                                      | 58 – 59, 63               | SAS 120      |
|                                      | 99, 102                   | SAS 200      |
|                                      | 132                       | SAS 300      |
|                                      | 172                       | SAS 480      |
| Cash Donations and Donations in Kind | 20 - 21                   | Introduction |
|                                      | 42                        | SAS 110      |
|                                      | 132, 135 (tables 1 and 2) | SAS 300      |
|                                      | 140, 143                  | SAS 400      |
|                                      | 149                       | SAS 410      |
| 4 Completeness of Income             | 21-22                     | Introduction |
|                                      | 138-143                   | SAS 400      |
| Grant Income                         | 23                        | Introduction |
|                                      | 85 – 86                   | SAS 130      |

|                           |                    |              |
|---------------------------|--------------------|--------------|
|                           | 91                 | SAS 140      |
|                           | 104 -105           | SAS 210      |
|                           | 132, 135 (table 3) | SAS 300      |
|                           | 143                | SAS 400      |
| Overseas Operations       | 42                 | SAS 110      |
|                           | 99                 | SAS 200      |
|                           | 115                | SAS 210      |
|                           | 136                | SAS 300      |
|                           | 144 –148           | SAS 400      |
| Restricted Funds          | 25 – 26            | Introduction |
|                           | 84, 86             | SAS 130      |
|                           | 91                 | SAS 140      |
|                           | 116, 118           | SAS 220      |
|                           | 132, 135 (table 5) | SAS 300      |
|                           | 169                | SAS 470      |
| Trading Activities        | 27 – 29            | Introduction |
|                           | 67, 68             | SAS 120      |
|                           | 99                 | SAS 200      |
|                           | 132                | SAS 300      |
| Trustees' Report on Risks | 97                 | SAS 160      |
|                           | 202                | SAS 600      |
| Taxation                  | 29 – 31            | Introduction |
|                           | 67 – 69            | SAS 120      |

# APB STATEMENT OF STANDARDS FOR REPORTING ACCOUNTANTS APPLICABLE TO SMALL (CHARITABLE) COMPANIES

*Since the Statement of Standards was issued, the legislation has been amended so that the provisions set out below are now only applicable to small charitable companies. The Statement is, however, reproduced in its original form without amendments to reflect either the change of legislation or to make it specific to charitable companies.*

Certain smaller charitable companies are exempt from the requirement for an audit under the provisions of the Companies Act 1985. Reporting Accountants engaged to report on the financial statements of such charities follow the procedures for making audit exemption reports contained in the Statement of Standards set out below.

## **Audit exemption reports**

This statement sets out the basic principles and essential procedures, indicated by paragraphs in bold type, to be observed by reporting accountants engaged to prepare a report for the purposes of section 249A (2) of the Companies Act 1985 ('the Act') on the accounts of a small company; it also includes explanatory and other material which, rather than being prescriptive, is designed to assist reporting accountants.

The limited nature of such a report derives from the relevant legislation and this statement has been prepared in consultation with the DTI.

In this statement, the word 'report' is used to refer to the report for the purposes of section 249A (2). A summary of some of the key points of the legislative background to such reports is given in Appendix 1. For a proper understanding of the statutory requirements, however, reference should be made to the Act.

## **Accountancy work performed by reporting accountants**

The directors of small companies usually engage an accounting firm to assist them to comply with the statutory responsibility to prepare annual accounts. Often the same accounting firm is engaged both to assist with accounts preparation (and related accountancy work) and to act as reporting accountants.

The procedures performed by the accounting firm in the preparation of the accounts will often be directly relevant to the report, but will not necessarily be sufficient to enable them to express all of the opinions which the Act requires in the report. However, where the accounting

firm has prepared the accounts from the accounting records, and is satisfied that its procedures comply with paragraphs 1 to 17 of this statement, no additional work will be required in order to express the opinions which are to be provided in the report.

### **Objective of the engagement**

**1 The reporting accountants should perform such procedures as are necessary to provide a reasonable basis on which to express the opinions which are to be provided in the report.**

1.1 The report requires opinions to be expressed on three specific matters and provides assurance only on those matters (see Appendix 1). The reporting accountants' work is designed to provide a reasonable basis for these opinions. As the scope of the opinions is narrow, the reporting accountants' procedures are limited and much less extensive than, for example, in an audit.

1.2 In particular, the reporting accountants do not consider the completeness, accuracy and validity of the accounting records; nor do they consider whether the accounts give a true and fair view, the company's compliance with applicable accounting standards, the treatment of events after the balance sheet date, the appropriateness of the going concern basis, or the company's compliance with other laws and regulations.

### **Agreeing the terms of the engagement**

**2 The reporting accountants and the directors should set out in writing and agree on the terms of the engagement.**

2.1 To qualify for the exemption it is necessary for the directors to cause a report to be prepared. It is therefore in the interests of both the reporting accountants and the company that the reporting accountants send a letter confirming their acceptance of the appointment and documenting the key terms of the engagement.

2.2 If the reporting accountants already have an appointment as auditors of the company, under terms specified in an existing audit engagement letter, a new engagement letter will need to be agreed. There is no requirement to resign from the appointment as auditors. However, if it appears likely that the company will not require an audit of its accounts for the foreseeable future, then, in order to avoid any possible confusion, the accounting firm may wish to resign as auditors (and to make the statement required by section 394). In such circumstances the reporting accountants and the directors may agree terms of engagement on a continuing rather than an annual basis.

2.3 Matters dealt with in the engagement letter will normally include:

- (a) the respective responsibilities of the directors and of the reporting accountants;
- (b) the scope of the reporting accountants' work;

- (c) the circumstances in which, and the form in which, a report can be issued; and
- (d) the terms of any non-statutory professional services to be provided by the reporting accountants (for example, to assist the directors in preparing the accounts).

2.4 The reporting accountants can agree with the directors a limit on any liability arising out of the work. Section 310, which would make void any such agreement made by an auditor, does not apply to this or any other non-audit engagement. Legal advice may be required regarding the terms of any such agreement and on the form of words to be included in the engagement letter.

2.5 An illustrative example of an annual engagement letter for this type of engagement is given in Appendix 2.

### **Ethical considerations**

#### **3 In the conduct of the engagement, the reporting accountants should comply with the ethical guidance issued by their relevant professional body.**

3.1 The users of the report will reasonably expect the reporting accountants to have had regard to the appropriate ethical considerations; these include, *inter alia*, integrity, objectivity, professional competence and due care, and confidentiality. In addition, the reporting accountants are required by section 249D(4) to be independent of the company.

### **Planning**

#### **4 The reporting accountants should plan their work so that an effective engagement is performed.**

4.1 As part of their planning procedures, the reporting accountants will make specific and timely enquiries to obtain the directors' confirmation that, to the best of their knowledge and belief, they expect that:

- (a) the company will satisfy the report conditions; and
- (b) the company has not fallen, and will not fall, into any of the cases where the exemption is not available;

and whether they require a report to be prepared. In considering whether a report is to be prepared, the directors will have regard to any undertakings given to third parties which may require an audit to be carried out, for example, where an audit is a condition of a loan covenant.

4.2 Obtaining an understanding of the procedures to be adopted for the accounts to be prepared, and of the form of accounting records kept by the company, is an important part of planning: it assists the reporting accountants to tailor the specific procedures to be performed having regard to the circumstances of the particular engagement. The accounting records are

those kept by the company under section 221 and do not include, for example, any statutory register or minute book kept by the company.

## **Documentation**

**5 Working papers should adequately record the reporting accountants' planning and the procedures performed, and should provide evidence that the work was carried out in accordance with these standards and support the conclusions drawn.**

5.1 The extent of working papers is a matter of professional judgement, since it is neither necessary nor practicable to document every matter the reporting accountants consider.

5.2 Working papers normally include:

- the engagement letter;
- a description of the accounting records kept by the company;
- evidence of the planning process;
- a record of the nature, timing and extent of the procedures undertaken and the results of such procedures (including a copy of any Companies Act accounts disclosure checklist which has been used);
- a written record of any information or explanations from the board of directors which the reporting accountants regard as being of importance to their opinion;
- copies of the final trial balance, of the accounts and of the report.

A separately documented work programme is not necessary, provided the work planned and performed is recorded.

## **Work delegated to assistants**

**6 Work delegated to assistants should be directed, supervised and reviewed in a manner which provides confidence that such work is done competently and in accordance with these standards.**

6.1 Appropriate arrangements need to be in place to ensure that any assistants to whom work is delegated are adequately briefed on their responsibilities and the objectives of the procedures they are to perform. The progress of the engagement needs to be monitored and the work performed by each assistant needs to be reviewed by personnel of at least equal competence, to ensure that the procedures have been performed as planned and have been adequately documented, and that any significant matters have been properly identified, so that the objectives of the engagement may be met.

## Procedures

### ***Accounts in agreement with the accounting records***

**7 The reporting accountants should perform such procedures as are necessary to provide a reasonable basis on which to express an opinion on whether the accounts are in agreement with the accounting records.**

7.1 Procedures relating to this objective will comprise comparison of the accounts with the accounting records. The reporting accountants will need, inter alia, to agree all balances in the accounts with the general ledger, via the trial balance. Postings from the books of prime entry (in whatever form these are kept by the company) to the general ledger will need to be agreed on a test basis, checking items in each direction. In deciding the number of items to test, and the basis of their selection, the reporting accountants will have regard to the need to obtain a reasonable basis for the opinion expressed.

7.2 However, the reporting accountants do not carry out procedures to enable them to form an opinion on whether proper accounting records have been kept, or to check the arithmetical accuracy of the accounting records. Entries in the accounting records do not need to be checked to source documents (such as invoices). In those cases where no other accounting records are kept, source documents can be regarded as constituting the accounting records.

7.3 For the purposes of this opinion the reporting accountants will disregard 'de minimis' differences between the accounts and the accounting records.

### ***Accounts drawn up in a manner consistent with the specified accounting requirement***

**8 The reporting accountants should perform such procedures as are necessary to provide a reasonable basis on which to express an opinion on whether, having regard only to, and on the basis of, the information contained in the accounting records, the accounts have been drawn up in a manner consistent with the accounting requirements specified in section 249C(6).**

8.1 The reporting accountants only consider the information contained in the accounting records. Their objective is to be satisfied that, on the basis of whatever accounting records have been kept by the company, the accounts have been prepared from them in the form laid down by the specified requirements.

8.2 For example, in relation to an amount included in the accounting records purporting to represent fixed assets (say, plant and machinery), the reporting accountants will need to consider whether:

- it is included in the balance sheet:
  - in the appropriate caption in one of the formats prescribed by Schedule 4; and

- with an appropriate description prescribed by Schedule 4 ('tangible fixed assets');
- it is included in the balance sheet on a basis permitted by Schedule 4; and
- provision is made for depreciation as required by Schedule 4.

The reporting accountants may find it helpful to use a Companies Act accounts disclosure checklist in this part of the engagement.

8.3 The reporting accountants are not required to perform procedures designed to obtain evidence to support the entries in the accounting records, the existence, ownership or value of assets, or the completeness of income, liabilities and disclosures in the accounts. Nor do they make any assessment of the estimates or judgements made by the directors in the preparation of accounts, or of whether the accounts comply with applicable accounting standards.

#### ***Entitlement to exemption from an audit***

**9 The reporting accountants should perform such procedures as are necessary to provide a reasonable basis on which to form an opinion on whether, having regard only to, and on the basis of, the information contained in the accounting records, the company is entitled to exemption from an audit.**

9.1 Procedures relating to this objective will comprise:

- (a) inspection of the accounting records to establish whether the report conditions appear to have been met; and
- (b) consideration of whether, at any time within the year, the company fell into any of the categories not entitled to the exemption from an audit of the accounts.

9.2 For this purpose the reporting accountants accept the information contained in the accounting records kept by the company, without attempting to further verify or substantiate the basis on which entitlement to the exemption is claimed by the directors. Where the reporting accountants are satisfied that the accounts are in agreement with the accounting records, it may be possible to form the required opinion on entitlement to the exemption on the basis of turnover and balance sheet totals shown in the accounts.

9.3 The reporting accountants' knowledge of the company will normally provide a sufficient basis on which to consider whether the company is in any of the categories of company not entitled to the exemption. The reporting accountants will, however, need to remain alert, throughout the engagement, for any information which might come to light indicating that the company may, at some time in the financial year, have fallen into one of the categories of companies not entitled to the exemption.

### ***Discussions with the board of directors***

10 If the reporting accountants either:

- (a) **have doubts whether the results of their procedures provide a reasonable basis on which to express an affirmative opinion on each of the matters specified by the Act;**  
**or**
- (b) **have become aware of information which indicates to them that the accounts may be misleading,**

**the matters giving rise to their concern should be discussed with the directors.**

10.1 The reporting accountants' concern may be dispelled by information and explanations supplied by the directors, or by the directors making appropriate amendments to the accounts (for the accounting records). The reporting accountants do not seek independent evidence to corroborate information or explanations provided by the directors.

10.2 The reporting accountants are not required to perform procedures designed to obtain evidence that the accounts are not misleading. Nevertheless, in the normal course of their work they may become aware of information which may indicate to them that the accounts may be misleading. Practising accountants have a professional responsibility not to allow their names to be associated with accounts which they believe may be misleading, and will therefore discuss with the directors any such matters which have come to their attention.

**11 If the reporting accountants conclude that the company did not satisfy the conditions for exemption from an audit of the accounts, or that it did not fall within the categories of companies entitled to the exemption, or if they are unable to reach a conclusion on either of these matters, no report can be issued. The reporting accountants should notify the directors in writing of the reason without undue delay.**

11.1 Section 249C(3) specifies that the report shall 'state that in the opinion of the reporting accountant . . . the company satisfied the [report conditions]'; the Act does not permit this opinion to be qualified. Therefore, no report is issued if, in the opinion of the reporting accountants, the report conditions are not satisfied, or if they remain uncertain whether those conditions are satisfied. In such circumstances an audit of the accounts is required.

### **Reporting**

**12 If the reporting accountants are satisfied that the results of their procedures provide a reasonable basis on which to express an affirmative opinion on each of the matters specified by the Act, they should issue a report including such an opinion.**

12.1 An illustrative example of such a report is given in Appendix 3.

**13 The report should include the following matters:**

- (a) a title identifying the shareholders of the company as the persons to whom the report is addressed;
- (b) an introductory paragraph identifying the accounts reported on;
- (c) a statement that the directors are responsible for the preparation of the accounts;
- (d) a description of the basis of the reporting accountants' opinion;
- (e) the reporting accountants' opinion;
- (f) the name and signature of the reporting accountants;
- (g) the date of the report.

### ***Addressee***

13.1 The report is to be made to the members of the company, who are normally the shareholders (section 249A(2)).

### ***Directors' responsibilities***

13.2 A company is not entitled to the exemption unless the balance sheet includes a statement by the directors acknowledging their responsibilities for ensuring that the company keeps accounting records which comply with section 221 and for preparing accounts which give a true and fair view and which otherwise comply with the requirements of the Act (section 249B(4)(c)). It is sufficient for the report to include a reference to that statement rather than reproducing it in full.

### ***Basis of opinion***

13.3 This section of the report describes the scope of the engagement, to enable the reader to understand the nature of the procedures performed and the assurance expressed.

### ***Name and signature of the reporting accountants***

13.4 The copy of the report which is delivered to the registrar of companies is required to state the name of, and to be signed by, the reporting accountants. Copies of the report laid before the company in general meeting, or which are otherwise circulated, published or issued, need only state the name of the reporting accountants.

13.5 The report is signed in the name of the accounting firm, indicating their capacity as reporting accountants.

### ***Date of the report***

13.6 The date of the report is the date on which the reporting accountants sign the report. The reporting accountants do not date the report earlier than the date on which the accounts are approved by the directors.

## **Modification of the report**

### ***Disagreement***

14 If the reporting accountants conclude that in respect of a particular matter either:

- (a) the accounts are not in agreement with the accounting records kept by the company under section 221; or**
- (b) the accounts have not been drawn up in a manner consistent with the accounting requirements specified in section 249C(6):**

**they should issue a report including a negative opinion in respect of the relevant part of the opinion section.**

14.1 The negative opinion indicates that, in the opinion of the reporting accountants, because of the matter in question, the relevant requirement has not been met. An illustrative example of a report containing a negative opinion is given in Appendix 4.

14.2 If the reporting accountants express a negative opinion in respect of one of the matters specified by the Act, they may need to consider the implications for the other opinions. For example, if the reporting accountants conclude that the accounts do not agree with the accounting records, it will be necessary to consider whether that particular matter raises doubts about the company's entitlement to the exemption from an audit of the accounts.

14.3 However, the fact that the reporting accountants identify a matter giving rise to a negative opinion does not of itself give rise to a need to perform additional or more extensive procedures in relation to other aspects of the accounts or of the accounting records.

### ***Limitation on scope***

15 If a limitation on the scope of the reporting accountants' procedure prevents them from obtaining a reasonable basis for an opinion as to whether either:

- (a) the accounts are in agreement with the accounting records kept by the company under section 221; or**
- (b) the accounts have been drawn up in a manner consistent with the accounting requirements specified in section 249C(6):**

**they should issue a report including a qualified opinion in respect of the relevant part of the opinion section.**

15.1 A limitation on scope may be:

- (a) imposed by the directors (for example, where they refuse to provide information or explanations requested by the reporting accountants); or**

- (b) imposed by circumstances (for example, where parts of the accounting records have been lost or destroyed).

15.2 If there is a limitation on scope due to the absence of part of the accounting records, the reporting accountants may nevertheless be able, by comparing the accounts with the remaining accounting records (including any source documents which may be available), to conclude that the company satisfied the report conditions and that a report can be issued (see paragraph 11.1). In such circumstances, the opinion as to whether the accounts are in agreement with the accounting records will be qualified; the reporting accountants will need to consider whether the limitation on scope prevents them from forming an opinion as to whether the accounts have been drawn up in a manner consistent with the specified accounting requirements.

15.3 The qualified opinion indicates that it is expressed 'except for' the matter in question. An illustrative example of a report where there has been a limitation on scope is given in Appendix 5.

#### ***The use of an explanatory paragraph***

**16 If the reporting accountants have become aware of information which indicates to them that the accounts may be misleading, and their concern cannot be resolved by procedures which are within the scope of the examination, they should add an explanatory paragraph to the 'basis of opinion' section of the report, referring to the matter. It should be clearly stated that no opinion is expressed on the matter referred to.**

16.1 If the reporting accountants' concerns have not been resolved by discussion with the directors, a negative or qualified opinion will be inappropriate if the matter in question is one that is outside the scope of the opinions required by the Act. In such cases the matter is highlighted by means of an additional explanatory paragraph in the 'basis of opinion' section of the report, to provide readers with a proper understanding of the basis of the opinion. An illustrative example of a report including an explanatory paragraph is given in Appendix 6.

16.2 The inclusion of an explanatory paragraph indicates only that the reporting accountants have become aware of that matter in the course of carrying out their procedures. When no explanatory paragraph is included this does not signify that the reporting accountants have satisfied themselves that the accounts are not misleading, but only that no matters have come to their attention to suggest otherwise.

#### **Circumstances which may lead to resignation**

**17 If the reporting accountants either:**

- (a) **have become aware of information which indicates to them that the accounts may be misleading, and they conclude that the matter cannot be adequately dealt with by means of modification of their report; or**

**(b) have serious doubts about the integrity of the directors,**

**the reporting accountants should resign from the engagement, notifying the directors in writing of the reason without undue delay.**

17.1 Where the reporting accountants identify several different matters, each giving rise to a separate reason to modify the report, it will be necessary to consider the nature of the matters in question, and whether their combined effect is such as to raise doubts as to whether the reporting accountants can be associated with the accounts.

17.2 The reporting accountants may need to take legal advice on the wording of any letter of resignation relating to the integrity of the directors.

### **Appendix 1 - Legislative background**

*This appendix summarises some of the key points of the legislative background. For a proper understanding of the statutory requirements, however, reference should be made to the Act.*

#### **Exemptions from audit**

1 The Act confers exemptions from audit for certain categories of small company: under section 249A(1) those companies which meet the 'total exemption conditions' (section 249A(3)) in respect of a financial year are exempt from the obligation to have their annual accounts audited, whilst under section 249A(2) those meeting the 'report conditions' (section 249A(4)) are similarly exempt if the directors cause a report to be prepared in accordance with section 249C and made to the company's members by suitably qualified reporting accountants.

2 No statutory report is required in the case of a company which meets the total exemption conditions.

3 The report conditions specified in section 249A(4) are that:

- (a) the company qualifies as a small company in relation to that year for the purposes of section 246;
- (b) its turnover for that year is more than £90,000 but not more than £350,000 (*The turnover threshold was increased in 2000 to £1,000,000 for small companies other than charitable companies*);
- (c) its balance sheet total for the year is not more than £1.4 million.

For a company which is a charity, the report conditions are modified by section 249A(5): the reference to turnover is replaced by gross income, on which the limit is £250,000.

#### **The report**

4 Section 249C specifies that the report for the purposes of section 249A(2) is required to

state whether in the opinion of the reporting accountants making it:

- (a) the accounts of the company for the financial year in question are in agreement with the accounting records kept by the company under section 221, and
- (b) having regard only to, and on the basis of, the information contained in those accounting records, those accounts have been drawn up in a manner consistent with the provisions of the Act (i.e. accounting requirements) specified in section 249C(6), so far as they are applicable to the company.

The report also states that in the opinion of the reporting accountants, having regard only to, and on the basis of, the information contained in the accounting records kept by the company under section 221, the company satisfied the requirements of section 249A(4), modified by section 249A(5) where the company is a charity, for the financial year in question, and did not fall within the categories of company not entitled to the exemption specified in section 249B(1)(a) to (f) at any time within that financial year.

6 The provisions specified in section 249C(6) are:

- (a) section 226(3) and Schedule 4 ('Form and content of company accounts')
- (b) section 231 and paragraphs 7 to 9A and 13(1), (3) and (4) of Schedule 5 ('Disclosure of information: related undertakings')
- (c) section 232 and Schedule 6 ('Disclosure of information: emoluments and other benefits of directors and others')

where appropriate as modified by section 246(1)(a) and (1A) and section A of Part I of Schedule 8.

### ***Cases where exemptions are not available***

7 Section 249B(1) specifies that a company is not entitled to exemption in respect of a financial year if at any time within that year it was:

- (a) a public company;
- (b) a banking or insurance company;
- (c) enrolled in a list maintained by the Insurance Brokers Registration Council under section 4 of the Insurance Brokers (Registration) Act 1977;
- (d) an authorised person or appointed representative under the Financial Services Act 1986;
- (e) a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 or an employers' association as defined by section 122 of that Act; or a parent company or subsidiary undertaking.

8 Section 249B(4) specifies that a company shall not be entitled to exemption unless the balance sheet includes a statement by the directors acknowledging their responsibilities, *inter alia*, for:

- (a) ensuring that the company keeps accounting records which comply with section 221; and
- (b) preparing accounts which give a true and fair view and which otherwise comply with the requirements of the Act.

### **Abbreviated accounts**

9 If the directors of a company which satisfies the report conditions propose to take advantage of the exemptions conferred by Part III of Schedule 8 (exemptions with respect to delivery of accounts) and to deliver to the registrar of companies 'abbreviated accounts', a copy of the report for the purposes of section 249A(2) is also to be delivered to the registrar of companies.

10 No special report by the reporting accountants on the abbreviated accounts is required.

11 To avoid any possible confusion, however, the directors may choose to append to the copy of the report that is to be delivered some explanatory words, such as follows:

'The following reproduces the text of the report prepared for the purposes of section 249A(2) Companies Act 1985 in respect of the company's annual accounts, from which the abbreviated accounts (set out on pages . . . to . . .) have been prepared.'

### **Appendix 2 - Illustrative example of an engagement letter**

*This example is intended to illustrate the principles set out and the guidance given in the statement. In any particular engagement the letter will need to be tailored to the specific circumstances.*

*The reporting accountants' professional body may specify other matters which are to be included in an engagement letter.*

To the directors of . . .

The purpose of this letter is to set out the basis on which we are engaged:

- (a) to act as reporting accountants to prepare a report for the purposes of section 249A(2) Companies Act 1985 (the Act), in respect of the company's accounts for the year ended . . ., in accordance with section 249C of the Act; and
- (b) to provide other professional services to the company

and the respective responsibilities of the directors and of ourselves.

## **1 Responsibilities of the directors**

1.1 As directors of the company, you are responsible for ensuring that the company maintains proper accounting records and for preparing accounts which give a true and fair view and which have been prepared in accordance with the Act.

1.2 You are also responsible for determining whether, in respect of the year, the company needs the conditions for exemption from an audit of the accounts set out in section 249A of the Act, and for determining whether, in respect of the year, the exemption is not available for any of the reasons set out in section 249B.

1.3 If, in respect of the year, the availability of the exemption from an audit of the accounts is conditional upon your causing a report in respect of these accounts to be prepared for the purposes of section 249A(2), you are responsible for deciding whether that report shall be made and for appointing you as reporting accountants to make that report to the shareholders of the company.

## **2 Responsibilities of the reporting accountants**

2.1 We shall plan our work on the basis that a report for the purposes of section 249A(2) is required for the year, unless you inform us in writing that either:

- (a) the company requires an audit of the accounts; or
- (b) the company requires neither an audit nor such a report.

2.2 Should you instruct us to carry out an audit, then a separate letter of engagement will be required.

2.3 Should you inform us that the company requires neither an audit nor a report, then we shall have no responsibilities to the company, except those specifically agreed upon between us in respect of other professional services.

2.4 As reporting accountants, we have a statutory responsibility to report to the shareholders of the company whether in our opinion:

- (a) the accounts are in agreement with the accounting records kept by the company under section 221 of the Act; and
- (b) having regard only to, and on the basis of, the information contained in those accounting records, the accounts have been drawn up in a manner consistent with the accounting requirements specified in section 249C(6) of the Act, so far as they are applicable to the company.

2.5 We also have a statutory responsibility to state that, having regard only to, and on the basis of, the information contained in the accounting records kept by the company under

section 221, in our opinion the company satisfied the conditions for exemption from an audit of the accounts specified in section 249A(4) of the Act and did not, at any time within the year, fall within any of the categories, specified in section 249B(1), of companies not entitled to the exemption.

2.6 We do not have any responsibility to report whether any shareholder of the company has notified the company that he or she requires an audit, consequently we have no responsibility to carry out any work in respect of this matter.

2.7 Should our work lead us to conclude that the company is not entitled to exemption from an audit of the accounts, or should we be unable to reach a conclusion on this matter, then we will not issue any report and will notify you in writing of the reasons. In these circumstances, if appropriate, we will discuss with you the need to appoint an auditor.

### **3 Scope of the reporting accountants' work**

3.1 Our engagement will be conducted in accordance with the Statement of Standards for Reporting Accountants issued by the Auditing Practices Board. Our procedures will consist of comparing the accounts with the accounting records kept by the company, and making such limited enquiries of the officers of the company as we may consider necessary for the purposes of our report.

3.2 Our work as reporting accountants will not be an audit of the accounts in accordance with Auditing Standards. Accordingly, we will not seek any independent evidence to support the entries in the accounting records, the existence, ownership or value of assets, or the completeness of income, liabilities and disclosures in the accounts. Nor will we make any assessment of the estimates and judgements made by you in your preparation of the accounts. Consequently our work as reporting accountants will not provide any assurance that the accounting records or the accounts are free from material misstatement, whether caused by fraud, other irregularities or error.

3.3 We have a professional responsibility not to allow our name to be associated with accounts which we consider may be misleading. Therefore, although we are not required to search for such matters, should we become aware, for any reason, that the accounts may be misleading, and the matter cannot be adequately dealt with by means of modification of our report, we will not issue any report and will withdraw from the engagement, and will notify you in writing of the reasons.

3.4 As part of our normal procedures, we may request you to provide written confirmation of any information or explanations given by you orally during the course of our work.

3.5 We attach to this letter a specimen of the form of report, setting out, in the manner specified by the professional standards, the opinions required by the Act.

## 4 Accounting and other services

4.1 You have asked us to assist you in the maintenance of the accounting records and in the preparation of the accounts, as follows:

*(describe the work to be performed or refer to a separate letter of engagement)*

4.2 You have asked us to provide other professional services, in respect of . . .

*(describe the other services)*

4.3 Our engagement with the company as reporting accountants for the purpose of preparing the report is a statutory responsibility and is distinct, and entirely separate, from any obligations or responsibilities arising out of the contractual arrangements agreed between us under which we are to provide the professional services described in [4.1] to [4.2] above.

## 5 Limitation of liability

5.1 *(The reporting accountants can agree with the directors a limit on any liability arising out of the work. In such circumstances, legal advice may be required regarding the form of words to be included in the engagement letter.)*

## 6 Fees

6.1 Our fees are computed on the basis of time spent on the company's affairs by the partners and our staff, and on the level of skills and responsibility involved. Our fees will be charged separately for each of the main classes of work described above, will be billed at appropriate intervals during the year and will be due on presentation.

6.2 If, in the circumstances described in [2.7], we do not issue any report, or if, in the circumstances described in [3.3], or for any other reason, it becomes necessary for us to withdraw from the engagement, our fees for work performed will be payable by the company.

## 7 Agreement of terms

7.1 We shall be grateful if you could confirm in writing your agreement to the terms of this letter, or let us know if they are not in accordance with your understanding.

Yours faithfully

. . . .

## Appendix 3 - Illustrative example of report

### ACCOUNTANTS' REPORT TO THE SHAREHOLDERS ON THE UNAUDITED ACCOUNTS OF XYZ LIMITED

We report on the accounts for the year ended . . . set out on pages . . . to . . .

## **Respective responsibilities of directors and reporting accountants**

As described on page . . . the company's directors are responsible for the preparation of the accounts, and they consider that the company is exempt from an audit. It is our responsibility to carry out procedures designed to enable us to report our opinion.

## **Basis of opinion**

Our work was conducted in accordance with the Statement of Standards for Reporting Accountants, and so our procedures consisted of comparing the accounts with the accounting records kept by the company, and making such limited enquiries of the officers of the company as we considered necessary for the purposes of this report. These procedures provide only the assurance expressed in our opinion.

## **Opinion**

In our opinion:

- (a) the accounts are in agreement with the accounting records kept by the company under section 221 of the Companies Act 1985;
- (b) having regard only to, and on the basis of, the information contained in those accounting records:
  - (i) the accounts have been drawn up in a manner consistent with the accounting requirements specified in section 249C(6) of the Act; and
  - (ii) the company satisfied the conditions for exemption from an audit of the accounts for the year specified in section 249A(4) of the Act as modified by section 249A(5) and did not, at any time within that year, fall within any of the categories of companies not entitled to the exemption specified in section 249B(1).

*[Signature]*

*Reporting accountants*

*Date*

*[Address]*

## **Appendix 4 - Illustrative example of report: opinion including disagreement**

### **ACCOUNTANTS' REPORT TO THE SHAREHOLDERS ON THE UNAUDITED ACCOUNTS OF XYZ LIMITED**

We report on the accounts for the year ended . . . set out on pages . . . to . . .

## **Respective responsibilities of directors and reporting accountants**

. . .

## **Basis of opinion**

. . .

## **Opinion - including disagreement**

As stated in note . . . , the directors have made no provision in the accounts for the depreciation of plant and machinery shown in the balance sheet at £. . . Paragraph 18 of Schedule 4 to the Companies Act 1985 requires that any fixed asset which has a limited useful economic life be depreciated.

In our opinion:

- (a) the accounts are in agreement with the accounting records kept by the company under section 221 of the Companies Act 1985;
- (b) having regard only to, and on the basis of, the information contained in those accounting records:
  - (i) because of the absence of the provision for depreciation referred to above, the accounts have not been drawn up in a manner consistent with the accounting requirements specified in section 249C(6) of the Act; and
  - (ii) the company satisfied the conditions for exemption from an audit of the accounts for the year specified in section 249A(4) of the Act and did not, at any time within that year, fall within any of the categories of companies not entitled to the exemption specified in section 249B(1).

*[Signature]*

*Reporting accountants*

*Date*

*Address*

## **Appendix 5 - Illustrative example of report:**

### **opinion including limitation on scope**

#### **ACCOUNTANTS' REPORT TO THE SHAREHOLDERS ON THE UNAUDITED ACCOUNTS OF XYZ LIMITED**

We report on the accounts for the year ended . . . set out on pages . . . to . . .

### **Respective responsibilities of directors and reporting accountants**

#### **Basis of opinion**

Our work was conducted in accordance with the Statement of Standards for Reporting Accountants, and so our procedures consisted of comparing the accounts with the accounting records kept by the company, and making such limited enquiries of the officers of the company as we considered necessary for the purpose of this report, except that the scope of our work was limited as explained below. These procedures provide only the assurance expressed in our opinion.

Owing to flood damage, certain accounting records relating to sales for the first month of the year have been destroyed, and so we have been unable to compare the sales shown in the accounts with those accounting records.

## **Opinion - including limitation on scope**

In our opinion:

- (a) except for the uncertainty relating to sales, which arises from the limitation on the scope of our work described above, the accounts are in agreement with the accounting records kept by the company under section 221 of the Companies Act 1985.
- (b) having regard only to, and on the basis of, the information contained in those accounting records:
  - (i) the accounts have been drawn up in a manner consistent with the accounting requirements specified in section 249C(6) of the Act; and
  - (ii) the company satisfied the conditions for exemption from an audit of the accounts for the year specified in section 249A(4) of the Act and did not, at any time within the year, fall within any of the categories of companies not entitled to the exemption specified in section 249B(1).

*[Signature]*

*Reporting accountants*

*Date*

*Address*

*Note:* In this example the reporting accountants have been able to conclude that the company satisfied the report conditions and that the limitation of scope did not prevent them from forming an opinion as to whether the accounts had been drawn up in manner consistent with the specified accounting requirements.

## **Appendix 6 - Illustrative example of report:**

### **including explanatory paragraph**

#### **ACCOUNTANTS' REPORT TO THE SHAREHOLDERS ON THE UNAUDITED ACCOUNTS OF XYZ LIMITED**

We report on the accounts for the year ended . . . set out on pages . . . to . . .

#### **Respective responsibilities of directors and reporting accountants**

. . .

#### **Basis of opinion**

. . .

#### *Trade debtors*

In carrying out our procedures it has come to our attention that the balance sheet total of debtors includes a debt of £. . . which has been outstanding for in excess of one year. XYZ Limited has no security for this debt. The directors have made no provision against the debt being irrecoverable and they have informed us that they are satisfied that it will be recovered in full. We are not required to and have not performed any procedures to corroborate the directors' views, and we therefore express no opinion on this matter.

**Opinion**

. . .

*[Signature]*

*Reporting accountants*

*Date*

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