Audit of 2017/18 annual accounts (local authorities) - module 11 section 106 charities

Technical guidance note 2017/10(LA)

AUDIT SCOTLAND

Prepared for appointed auditors in the local authority sector

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1 Introduction

Purpose of module

1. This module of technical guidance note 2017/10(LA) provides guidance on the audit requirement for the statement of accounts of registered charities that fall within section 106 of the *Local Government (Scotland) Act 1973* (section 106 charities).

2. For those charities where the audit requirement applies, this module also provides information on, and guidance on the risks of misstatements in, the following areas of a section 106 charity's statement of accounts
   - Financial reporting framework.
   - Fund accounting.
   - Presentation of financial statements.
   - Investments.
   - Donations and legacies.
   - Grant expenditure.
   - Combinations and winding ups.
   - Miscellaneous disclosures.
   - Receipts and payments accounts.
   - Trustees' annual report.

3. This module also provides an update on the progress being made in rationalising the number of section 106 charities.

4. Other areas such as heritage assets may also apply to a section 106 charity, and auditors should refer to the relevant module.

Contact point for this module

5. The contact point in Audit Scotland's Professional Support for this module of the technical guidance note is Paul O'Brien, Senior Manager (Technical) - pobrien@audit-scotland.gov.uk

2 Section 106 charities audit requirement

Purpose of section

6. This section of the module provides information on the audit requirement for the statement of accounts of section 106 charities.

Definition

7. A section 106 charity is a trust fund where both the following criteria apply

   - The sole trustee is the local authority or all the trustees are members of the authority.
   - It is registered as a charity with the Office of the Scottish Charity Regulator (OSCR).

Explanation of audit requirement

8. Section 106 of the 1973 Act extends the audit requirement that applies to local authorities under section 99 of that Act (explained in the overview module) to any charities covered by that section. The audit of the statement of accounts prepared by registered charities is regulated by The Charities Accounts (Scotland) Regulations 2006 (the charity regulations).

9. The charity regulations require an auditor's report to accompany a charity's statement of accounts where, among other reasons, any legislation requires an audit. Appointed auditors are therefore required to prepare an independent auditor's report for each of the section 106 charity's statement of accounts.

Summary of auditor's responsibilities

10. In accordance with section 99, auditors are required to satisfy themselves that the statement of accounts of section 106 charities

    - have been prepared in accordance with The Local Authority Accounts (Scotland) Regulations 2014. However, the only requirements that apply to charities are the following
      - Regulation 9 which provides for the public inspection of the accounts.
      - Regulation 11 which requires the publication of the statement of accounts on the local authority's website.
    - comply with the requirements of the charity regulations
    - have been prepared in accordance with proper accounting practices (explained in section 3).

11. Auditors' responsibilities for section 106 charities' 2017/18 statement of accounts are to

- audit the financial statements and express an opinion on whether they give a true and fair view and are properly prepared in accordance with proper accounting practices
- read and consider the information in the trustees' annual report and express opinions as to whether it is consistent with the financial statements and prepared in accordance with proper accounting practices.

Risks of non-compliance

12. The following paragraphs highlight potential risks of non-compliance with the requirements for an audit and with other related issues, set out actions for auditors to undertake to assess whether the authority has followed the requirements, and explain how non-compliance should be addressed.

Section 106 charities are not identified

13. **Auditors should** assess whether the local authority has identified all the section 106 charities that it administers. The main determinant in assessing whether a charity falls within section 106 is the composition of the trustees as illustrated in the following table:

Trustees	Section 106 charity?
Council is sole trustee	YES
All local authority members are sole trustees	YES
Some local authority members are sole trustees	YES
Trustees include local authority officers acting as the authority	YES
Trustees include local authority officers not acting as the authority	NO
Trustees include individuals external to the local authority	NO

14. In most cases it is clear whether section 106 applies to a charity (e.g. where all the trustees are elected members). In other cases, however, the trustees may include local authority officers. Audit Scotland obtained legal advice to the effect that section 106 may still apply in these circumstances if there is evidence that the officers in question are 'acting as the authority'. Possible evidence in this regard is summarised is the following table:

Evidence	Comments
Governing document states that the officer is acting on behalf of the authority	The strongest evidence would be where the wording of the governing document explicitly states that the officer is 'acting on behalf of' or 'representing' the authority.
Governing documents refer to the delegation of a local authority function to the trustees	Strong evidence that officers are acting as the authority is also provided where the governing documents refer to the trustees being delegated responsibility for a local authority function.
Legislative requirement to nominate an officer	A case can also be made where there is a legislative requirement for the authority to nominate an officer as trustee, as is the case with section 16 of the *Local Government (Scotland) Act 1994*.
Representation from local authority	This might be the case where the local authority expresses the view that the officers are acting on its behalf.

15. Where there is uncertainty over whether section 106 applies to a charity, **auditors should** contact Audit Scotland's Professional Support for advice.

Number of section 106 charities is not reducing

16. **Auditors should** assess whether the local authority is making reasonable progress in rationalising the number of section 106 charities that it administers. Local authorities have traditionally administered a significant number of small section 106 charities. Audit Scotland has advised auditors for several years to strongly encourage authorities to reorganise their charities through merging or winding them up. This would have the benefit of reducing the number of charities that authorities require to administer and account for, and that auditors require to audit.

17. While there has been some progress in authorities rationalising their number of charities, it appears there remains considerable scope for further reductions. The following table provides a summary of the total number of section 106 charities, and the progress in reducing the total numbers since 2013/14:

Year	Number of section 106 charities	Rationalisation progress
2013/14	384	-
2014/15	389	(5)
2015/16	307	82
2016/17	270	37

18. Appendix 1 shows an analysis of the total by local authority. **Auditors should** engage with their authorities and encourage them to rationalise the number of charities, particularly where there is a significant number and little or no progress was made in 2016/17. **Auditors should** report the authority's progress in the 2017/18 annual audit report, with a recommendation to improve where the rate of progress is not considered acceptable.

Connected charities provisions are not used

19. While the long term aim is to rationalise the number of section 106 charities, the overall number of separate sets of statements of accounts that are required can be reduced by the effective application of the connected charities provisions under The Charities Accounts (Scotland) Regulations 2006. Regulation 7 (as amended in 2010) permits a single set of accounts for charities if they have common or related purposes, or shared management (i.e. connected charities). This would be the case where charities have common trustees.

20. There were 91 sets of accounts in 2016/17 (down 12 from 103 in 2015/16). Appendix 2 shows an analysis by council and indicates the extent to which the connected charities provisions were applied in 2016/17. The following table provides a summary in respect of the 24 councils with more than one charity:

Application of connected charities provisions	Number of local authorities
In full	11
Partial (but scope for further use)	2
None (but scope for use)	9
None (no scope for use)	2

21. Auditors of the relevant 11 local authorities indicated in Appendix 2 that have made only partial or no use of the connected charities provisions should encourage them to make full use in 2017/18, so that the total number of sets of accounts that requires to be audited is minimised.

Audit of section 106 charity not carried out

22. The audit appointments of the administering local authorities include the requirement to provide an independent auditor's report for section 106 charities. Auditors are therefore required to carry out an audit of the statement of accounts of any registered charity which falls within section 106. The audit deadline of 30 September that applies to local authorities also applies to section 106 charities.

23. When a charity is wound up, the charity regulations require the submission of the statement of accounts and independent auditor's report to OSCR within 9 months of the date of removal

from the charity register. The financial period covered by the accounts would be from 1 April to the day on which the charity was removed from the register.

24. However, in practice, OSCR allows two exceptions to this requirements, which are summarised in the following table:

Exception	Explanation
OSCR allows a derogation from the requirement for part year accounts	Where an authority can demonstrate (e.g. through correspondence with OSCR) that part year accounts are not required for 2017/18 for a charity wound up during the year, there would be no requirement for an independent auditor's report.
The application to wind up the charity was submitted prior to 31 March 2014	Audit Scotland agreed with OSCR in previous years that an audit of a section 106 charity was not required where an application to wind up the charity was submitted prior to 31 March 2014. OSCR's winding up process generally only lasts a few months and therefore this exemption is unlikely to apply in practice in 2017/18. However, if a section 106 charity was wound up during 2017/18, and the application was submitted prior to 31 March 2014, an audit of the 2017/18 statement of accounts would not be required.

25. **Auditors should**

- identify if any charities have been removed from the register during 2017/18
- establish whether OSCR require part year 2017/18 accounts
- where part year accounts are required, establish whether the application was submitted prior to 31 March 2014
- where the application for removal was after 1 April 2014, and part year accounts are required, audit the 2017/18 accounts for the appropriate period and provide an independent auditor's report to a timescale that allows the submission of the accounts and independent auditor's report within nine months of the date of removal.

26. Auditors may be approached by local authorities with a request to carry out audits for trust funds where section 106 does not apply. Auditors appointed by the Accounts Commission are eligible to carry out the audit in these circumstances under the charity regulations. Auditors are encouraged to accept a request of this nature but should treat this as non-audit work (i.e. a local arrangement outwith the local authority audit appointment) and follow the usual requirements as set out in the audit planning guidance.

3 Proper accounting practices

Purpose of section

27. This section of the module provides information on the proper accounting practices that section 106 charities are required to follow.

Changes in 2017/18

28. There are no changes in proper accounting practices in 2017/18.

Summary of proper accounting practices

29. Section 12 of the 2003 Act requires local authorities to observe proper accounting practices, which includes those required by any enactment. The Charities and Trustee Investment (Scotland) Act 2005 (the 2005 Act) requires charities to follow the requirements of the charity regulations.

30. The charity regulations require charities to follow the Accounting and reporting by charities: statement of recommended practice based on FRS 102 (charities SORP) when preparing their accounts on an accruals basis, and set out the requirements when accounts are prepared on a receipts and payments basis.

Sources of guidance on proper accounting practices

31. OSCR have provided guidance on the charity regulations in Scottish charity accounts - An updated guide to the 2006 regulations.

Risks of misstatement

32. The following paragraphs highlight potential risks of misstatement in respect of proper accounting practices, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

The correct accounting basis is not adopted

33. Regulation 8 (as amended) of the charity regulations requires accrued financial statements to be prepared by a charity that has a gross income for the year of £250,000 or more. Regulation 9(4) also requires accrued financial statements where

- the constitution or any enactment requires the charity to prepare accrued financial statements or those that give a true and fair view of its financial affairs; or
- the trustees have decided that they will prepare accrued financial statements.

34. Section 106 charities are required to follow the charities SORP when preparing their accounts on an accruals basis in accordance with regulation 8.

35. Where the terms set out by regulation 8 do not apply, regulation 9 permits charities to prepare their financial statements on a receipts and payments basis.

36. **Auditors should** confirm that the charity has prepared accrued financial statements for 2017/18 where

- gross income for the year is £250,000 or more; or
- the governing documents or any enactment require the charity to prepare accrued financial statements or those that give a true and fair view of its financial affairs; or
- the trustees have decided that they will prepare accrued financial statements.

Contents of the statement of accounts are not in accordance with the charity regulations

37. The following table provides a summary of requirements of the charity regulations in respect of the content of the statements of accounts (on an accrued and on receipts and payments basis):

<table>
<tr><th>Regulation 8 (accrued)</th><th>Regulation 9 (receipts and payments)</th></tr>
<tr><td>Statement of financial activities (SoFA)</td><td>Receipts and payment account</td></tr>
<tr><td>Balance sheet</td><td rowspan="2">Statement of balances</td></tr>
<tr><td>Cash flow statement (if turnover is above £6.5 million or gross assets above £3.26 million)</td></tr>
<tr><td colspan="2">Notes to the accounts</td></tr>
<tr><td colspan="2">Annual report from the charity trustees</td></tr>
</table>

38. **Auditors should** confirm that the statement of accounts include the required elements. Where a required element of the annual accounts is missing, **auditors should**

- consider whether its exclusion is appropriate
- request that the administering authority includes the missing element where its inclusion is required
- where an authority declines to include the required element, consider the impact on the affected opinion in the independent auditor's report.

Statement of responsibilities is not included

39. There is no explicit requirement for a charity's statement of accounts to include a statement of responsibilities. However, it is customary for accounts to include such a statement and some charities do so, though many do not.

40. Audit Scotland's Professional Support recommends that a statement should be included in the statement of accounts that explains for users the respective responsibilities of the trustees and of the auditors in relation to the financial statements. Such a statement should explain that the trustees are responsible for

- preparing financial statements in accordance with the charity regulations (and the charities SORP where on an accrued basis)
- selecting suitable accounting policies and applying them consistently (accrued basis)
- making judgements and estimates that are reasonable and prudent
- keeping adequate, up to date accounting records
- taking reasonable steps for the prevention and detection of fraud and other irregularities.

41. **Auditors should** encourage authorities to include a statement of responsibilities in the 2017/18 statement of accounts as a matter of good practice.

Governing documents are not complied with

42. The governing documents establish a charity's purpose and constitution, and are specific to each charity. They also specify the charitable activities and powers conferred on trustees. They are likely to take the form of a trust deed for section 106 charities, but may be another document such as letter or will.

43. **Auditors should** read the charity's governing documents and assess whether in 2017/18 any

- restrictions on how income or capital can be applied have been complied with
- special provisions as to the presentation or disclosure of information in the financial statements have been complied with
- significant non-compliance with a requirement is disclosed and adequately explained
- changes in the charity's activities, or new or unusual transactions, are in accordance with the governing document.

Governing documents are missing

44. In some cases, the authority may not be able to locate the governing documents for the charities it administers, particularly the older ones. **Auditors should** encourage the administering authority to contact OSCR as they hold documentation passed from HM Revenue and Customs and may be able to help.

45. If the governing documents still cannot be located, **auditors should**

- obtain and assess evidence from the administering authority that demonstrates that the charity's activities nevertheless meets its charitable purposes. This is expected to include obtaining appropriate representations from trustees and the authority's proper officer, and reviewing correspondence and reports for any indication of restricted funds
- confirm that there is an adequate explanation disclosed in the statement of accounts that the governing documents cannot be found and a clear and concise description of how trustees have assured themselves that the charity nevertheless meets its objectives
- assess whether the financial statements should be prepared on an accruals basis if there is any reason to believe that the missing governing documents may require an accruals basis, (e.g. where the trust deeds for other similar charities contain such a requirement).

46. There are a number of potential reporting implications for auditors where governing documents cannot be found. **Auditors should** contact Audit Scotland's Professional Support as the specifics may vary, but general guidance is provided in the following table:

Reporting option	Explanation
ISA(UK) 260 communication	The unavailability of governing documents is a significant difficulty encountered during the audit and is likely to be reported to trustees under *ISA(UK)260 Communication with those charged governance*.
Emphasis of matter paragraph under ISA(UK) 705	Where the absence of the governing documents is adequately explained in a disclosure in the statement of accounts, an emphasis of matter paragraph in the independent auditor's report may be appropriate to draw attention to that disclosure.
Qualified conclusion on adequacy of accounting records	The charity regulations require auditors to report if accounting records have not been kept. Auditors may judge that the absence of governing documents means that adequate accounting records have not been kept and report the matter accordingly.
Limitation of scope qualification	There may be uncertainty as to whether the missing governing documents specify restrictions on how income or capital can be applied. **Auditors should** perform and consider the results of alternative audit procedures, and assess the likelihood of restrictions that would require separate accounting. If auditors are unable to obtain sufficient appropriate evidence, they may judge that this constitutes a limitation on the scope of the audit and consider the impact on their opinion. If the likelihood of restrictions is judged to be remote, a qualification of the basis of limitation of scope would not be necessary.

47. **Auditors should** confirm that the authority has contacted OSCR to discuss how the absence of governing documents can be resolved for future years.

4 Fund accounting

Purpose of section

48. This section provides information on, and guidance on the risks of misstatement in, accounting for charitable funds.

Summary of proper accounting practices

49. Module 2 of the charities SORP sets out the requirements for the analysis and presentation of a charity's funds.

Risks of misstatement

50. The following paragraphs highlight potential risks of misstatement in respect of fund accounting, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Charitable funds are not properly accounted for

51. Fund accounting distinguishes between four classes of fund as explained in the following table:

Class of fund	Explanation
Unrestricted funds	These can be spent or applied at the discretion of the trustees to further any of the charity’s purposes. Unrestricted funds can be used to supplement expenditure made from restricted funds. They include funds that the trustees have decided to designate for a particular purpose. This may be because the donor expressed a non-binding preference as to the use of the funds, which falls short of imposing a restriction in trust law.
Restricted income funds	These require to be spent or applied within a reasonable period from their receipt to further a specific purpose of the charity. Restrictions on the use of the funds are generally declared by the donor when making the gift. It is possible that a charity may have several individual restricted funds, each for a particular purpose of the charity.
Permanent endowment funds (also known as capital funds).	An endowment where there is no power to convert the capital into income is known as a permanent endowment fund, which must normally be held indefinitely. Trust law requires a charity to invest the assets of an endowment, or retain them for the charity’s use to further its purposes.

Class of fund	Explanation
Expendable endowments	Where trustees have the power to convert endowment funds into income, such funds are known as expendable endowments. These are distinguishable from restricted income funds in that there is no actual requirement to spend or apply the capital until the trustees decide to do so.

52. **Auditors should** assess whether

- restricted income funds have been spent or applied during 2017/18
  - within a reasonable period from their receipt
  - to further one or more (but not all) of the charity’s charitable purposes. If the funds can be applied to all the charity's purposes, or the charity only has one purpose, they should be classified as unrestricted.
- each restricted fund, and the income received and expenditure made from it, has been separately identified in the accounting records
- costs charged to a restricted income fund relate to the activities undertaken to further the specific charitable purposes the fund was established to support. These costs include both direct and support costs associated with the activities undertaken by the restricted fund
- expenditure has been charged to a restricted income fund which is in deficit only when there is a realistic expectation that future income will be received to cover the shortfall
- the only expenses charged to permanent endowment funds are those incurred on the administration or protection of the investments or property of the endowment. Where the endowment has insufficient funds to meet the expenses that can be charged to it (or the terms of the trust prohibit the charging of expenses), the expenses have been charged to restricted income funds
- if the trustees exercised the power to spend or apply the capital of an expendable endowment during 2017/18, the relevant funds have become
  - unrestricted funds where the terms of the gift permit expenditure for any of the charity’s purposes
  - restricted income funds where the terms permit expenditure only for specific purposes.

Transfers between funds have not been properly accounted for

53. A transfer may be made between funds, for example

- to transfer assets from unrestricted funds to finance a deficit on a restricted fund
- where restricted funds have been lawfully released and transferred to unrestricted funds.

54. **Auditors should** check that any transfers during 2017/18 have been presented in the transfer line in the SoFA.

Information on funds has not been properly disclosed

55. Charities SORP paragraph 2.28 requires a charity to

- disclose information on
  - material individual fund balances
  - movements in the reporting period
  - the purposes for which the funds are held.
- differentiate unrestricted funds (both general and designated), restricted income funds, permanently endowed funds and expendable endowments.

56. Table 1 in the charities SORP provides an example of how the movements in material funds may be shown. Further disclosures are required by SORP paragraph 2.29.

57. **Auditors should**

- confirm that the trustees have complied with paragraphs 2.28 and 2.29 of the SORP in 2017/18
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

5 Presentation of financial statements

Purpose of section

58. This section provides information on, and guidance on the risks of misstatement in, the presentation of charities' financial statements on an accrued basis. Guidance on risks in respect of recognition and measurement of financial statement areas is provided in the relevant section of this module. Guidance on receipts and payments financial statements is provided at section 11.

Summary of proper accounting practices

59. Module 4 of the charities SORP sets out the requirements for the SoFA.

60. Module 10 of the SORP sets out the requirements for the balance sheet.

Risks of misstatement

61. The following paragraphs highlight potential risks of misstatement in respect of the presentation of financial statements, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

A complete set of financial statements is not properly presented

62. Regulation 8 requires a complete set of financial statements to comprise

- a SoFA which shows the total incoming resources and application of the resources, together with any movements in the total resources, of the charity during 2017/18
- a balance sheet which shows the state of affairs of the charity as at 31 March 2018
- a cash flow statement, if appropriate
- notes to the accounts

63. **Auditors should** assess whether the charity has

- presented a complete set of financial statements for 2017/18
- clearly identified the financial statements and distinguished them from the other information in the statement of accounts
- clearly identified each financial statement and the notes
- offset assets and liabilities or income and expenses only where required or permitted by the FRS 102 or the charities SORP
- presented corresponding amounts in respect of 2016/17 for each item presented

- adopted the same format for the financial statements as 2017/18, unless there are special reasons for a change that are explained in the notes
- omitted any line where there is nothing to report in both the current and previous reporting period.

Statement of financial activities is not properly presented

64. The SoFA is a single accounting statement that should include all income, gains, expenditure and losses recognised for 2017/18. The SoFA provides the user with
    - an analysis of the income and endowment funds received and the expenditure by the charity on its activities
    - a reconciliation of the movements in a charity's funds for 2017/18.

65. The options for the structure of the SoFA are summarised in the following table:

Options	Structure
Activity basis	The structure, format and headings of the SoFA are set out in Table 2 of the charities SORP.
Nature of income and expenditure	SORP paragraph 4.6 states that charities below the charity audit threshold may adopt an alternative approach to their analysis. This analysis may be based on the nature of the income and expenditure. For example, expenditure could be analysed by salary-related costs, premises-related costs, interest expenses, transport costs and grants made.
Accounting records	SORP paragraph 4.6 allows a charity to use the headings it uses to record expenditure in its own accounting records.

66. The columns of the SoFA should distinguish between restricted income funds, unrestricted funds, and endowment funds. If a class of funds is not considered material, it may be combined with another class of funds and shown as a single combined funds column. Where the charity applies this approach, the heading should be changed appropriately (e.g. to 'all unrestricted and restricted funds').

67. **Auditors should** confirm that
    - where an activity basis is used, the structure, format and headings of the SoFA have been set out in accordance with Table 2 of the charities SORP
    - where an alternative approach is adopted, the charity has presented in its SoFA the items listed at SORP paragraph 4.24
    - the columns of the SoFA distinguish between restricted income funds, unrestricted funds, and endowment funds

- classes of funds have been combined only where they are not considered material individually and, where the charity applies this approach, the heading has been changed appropriately.

Balance sheet is not properly presented

68. The objective of the balance sheet is to show the resources available to the charity and whether these are available for all purposes of the charity or have to be used for specific purposes because of legal restrictions placed on their use.

69. Table 5 of the charities SORP sets out the format of a charity's balance sheet and the headings used to present its assets, liabilities and funds. The balance sheet may also be presented in a columnar format that analyses balance sheet items by class of fund.

70. **Auditors should** assess whether

- the balance sheet has been properly presented in accordance with table 5 or in a columnar format
- where the corresponding amount for 2016/17 is not comparable due to a change in accounting policy, it has been adjusted and the reason for the adjustment explained in the notes to the accounts
- the balance sheet has been signed by one or more trustees, each of whom has been authorised to do so by the trustee body
- the balance sheet specifies the date the accounts, including the balance sheet, were approved by the trustee body.

6 Investments

Purpose of section

71. This section provides information on, and guidance on the risks of misstatement in, investments.

Definition

72. Investments are held to generate income and/or for their investment potential. The term includes cash on deposit and cash equivalents held for investment purposes.

73. An investment property is an interest in land and/or buildings whose construction and development is completed and is held for its investment potential with rental income being negotiated at arm's length.

Summary of proper accounting practices

74. Section 11 of FRS 102 sets out requirements for basic financial assets.

75. Section A4 of module 10 of the charities SORP sets out the classification and disclosures required for investments, and module 11 sets out the accounting requirements. Module 21 of the SORP sets out the requirements for accounting for social investments.

76. Section 16 of FRS 102sets out requirements for investment properties.

Risks of misstatement

77. The following paragraphs highlight potential risks of misstatement in respect of investments, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Investments are not identified or properly classified

78. Modules 10 and 21 of the charities SORP cover the different types of investments that charities may hold. These are summarised in the following table:

Type	Description
Fixed asset investments	Investments held to generate income and/or for their investment potential
Current asset investments	Investments held for resale or pending their sale Cash or cash equivalents with a maturity date of less than one year - includes cash on deposit and cash equivalents with a maturity of less than one year held for investment purposes rather than to meet short-term cash commitments as they fall due (may be invested in the administering authority's loans fund)
Programme related investments	Investments made primarily to further the charitable aims of the investing charity (social investments)
Mixed motive investments	Investments made both to generate an investment return and as a social investment

79. **Auditors should** assess whether

- the charity has identified all investments it holds during 2017/18
- investments have been properly classified.

Investments are not properly measured

80. The charities SORP's requirements for valuing investments are summarised in the following table:

<table>
<tr><th>Investment</th><th>Valuation requirement</th></tr>
<tr><td>Quoted shares, traded bonds and similar investments</td><td>Fair value (i.e. market value)</td></tr>
<tr><td>Unlisted equity investments</td><td rowspan="2">Best estimate of their market value or, where not available, cost</td></tr>
<tr><td>Social investments</td></tr>
</table>

81. **Auditors should**

- confirm that
  - investments in quoted shares, traded bonds and similar investments have been measured at their market value at 31 March 2018
  - unlisted equity investments have been measured at the best estimate of their market value, where practicable. Where valuation techniques are considered unreliable or the cost involved in the valuation outweighs the benefits, the investment should be included at its cost

  - social investments in the form of shares have been measured at either cost less any provision for diminution in value or at market value provided this can be measured reliably.
- assess whether the valuation of investments at 31 March 2018 is free from misstatement.

Investment income is not properly accounted for

82. Investment income is made up of
    - the income derived from the investment (e.g. interest, dividends, royalties or rents)
    - any gain or loss in the market value of the investment.

83. For unrestricted funds and restricted income funds, **auditors should** confirm that the returns have been allocated to the fund holding the investment. Income generated by the investment of a particular fund's assets accrues to that fund unless the terms of the initial gift provide otherwise.

84. In the case of endowment, SORP paragraph 2.25 states that trustees cannot normally add the income from investments to the endowment capital. **Auditors should** assess whether
    - income from the investment has been allocated to either unrestricted funds or a restricted income fund depending on the terms of the gift
    - any gain or loss on the investment market value has been attributed to the endowment capital
    - where a charity has several invested endowments, any gain or loss has been allocated correctly to each individual endowment.

85. **Auditors should** confirm that investment income receivable for 2017/18
    - has been presented as a separate heading on the face of the SoFA (where material)
    - is complete and free from misstatement.

Investment properties are not identified

86. **Auditors should** assess whether the charity has identified all the investment properties it held during 201718. Investment property is an interest in land and/or buildings
    - held for its investment potential with rental income being negotiated at an arm's length
    - the construction and development of which has been completed.

Investment properties have not been properly accounted for

87. **Auditors should** assess whether
    - investment properties have been measured at their market value at 31 March 2018
    - depreciation has been charged on investment property in 2017/18 where it is held on a lease with an unexpired term of 20 years or less.

Information on investments and investment properties is not properly disclosed

88. SORP paragraph 10.54 requires a charity to disclose

- the accounting policies for investments, including the basis on which investments are valued
- an analysis of investments by class of investment identifying the amounts held within each class, with those investments held at market value differentiated from those held at historical cost less any write down
- an analysis reconciling the opening and closing carrying amounts of each class of fixed asset investment held.

89. If the charity holds investment property, it is required to disclose

- the name or particulars of the qualifications of the person who undertook the valuation of investment property
- the bases used by them.

90. **Auditors should**

- confirm that the charity has complied with the charities SORP's disclosure requirements in 2017/18
- assess whether the disclosures are complete, clear, concise and free from misstatement.

7 Donations and legacies

Purpose of section

91. This section provides information on, and guidance on the risks of misstatement in, donations and legacies.

Definition

92. Donations and legacies include all income received by the charity that is, in substance, a gift made to it on a voluntary basis. A donation or legacy may be for any purpose of the charity (unrestricted funds) or for a particular purpose of the charity (restricted income funds or endowment funds).

Summary of proper accounting practices

93. Module 5 of the charities SORP sets out the requirements for the recognition of income including legacies. Module 6 covers donated goods and services.

Risks of misstatement

94. The following paragraphs highlight potential risks of misstatement in respect of donations and legacies, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Income from donations is not properly recognised

95. Income from donations should be recognised when the charity becomes entitled to it. Entitlement to a donation usually arises immediately on its receipt, unless there are any terms or conditions which must be met before the charity is entitled to the resources. A condition that simply restricts the use of a donation does not affect a charity's entitlement (although it does affect how the donation is reported in the accounts as explained in section 4).

96. **Auditors should**

- confirm that donations received during 2017/18 have been recognised as income when there is evidence of entitlement
- assess whether the amount of income is complete and free from misstatement.

Income from legacies is not properly recognised

97. Legacies should be recognised as income when the three conditions set out in the following table are met:

Condition	Explanation
Evidence of entitlement to the legacy	Entitlement to a legacy cannot arise without the charity knowing of both the existence of a valid will and the death of the benefactor. Evidence of entitlement to a legacy exists when the charity has sufficient evidence that a gift has been left to them and the executor is satisfied that the property in question will not be required to satisfy claims in the estate.
Receipt is probable	Receipt is normally probable when • there has been grant of probate, i.e. authority to the executer of the will to manage the disposal of assets • the executors have established that there are sufficient assets in the estate, after settling any liabilities, to pay the legacy • any conditions attached to the legacy are either within the control of the charity or have been met.
Amount can be measured reliably	In some cases, there may be uncertainty as to the amount of the payment. For example, the legacy may be subject to challenge or the charity's interest may be a residual one.

98. **Auditors should**

- confirm that legacies arising during 2017/18 have been recognised as income when the three above conditions have been met
- assess whether the amount of income is complete and free from misstatement
- where there is uncertainty that prevents the amount from being estimated reliably, confirm that the legacy has been disclosed as a contingent asset.

99. Where a payment is received from an estate or is notified as receivable by the executors after 31 March 2018 (and before the accounts are authorised for issue) but it is clear that the payment had been agreed by the executors prior to that date, **auditors should** confirm that it has been treated as an adjusting event and accrued as income if receipt is probable.

Donated facilities and services are not properly accounted for

100. In accordance with SORP paragraph 6.13, facilities and services donated to a charity for its own use which it would otherwise have purchased require to be recognised as income when received.

101. Donated facilities and services should be measured on the basis of the value of the gift to the charity. This is the amount that the charity would pay in the open market for an alternative item that would provide a benefit to the charity equivalent to the donated item. Value to the charity may be lower than, but cannot exceed, the price the charity would pay in the open market for the item.

102. An amount equivalent to the amount recognised as income for donated facilities and services should have been recognised as an expense under the appropriate heading in the SoFA.

103. An example of a donated service for a section 106 charity is where the administering authority absorbs the fees for the external audit of a charity's accounts. Where this is the case in 2017/18, **auditors should** confirm that the amount of the fees has been

- recognised in income as a donated service
- recognised as expenditure
- disclosed in the notes to the accounts.

Information on donated goods and services is not properly disclosed

104. SORP paragraph 6.31 requires a charity to disclose

- the accounting policy for the recognition and valuation of donated goods, facilities and services
- the nature and amounts of donated goods, facilities and services receivable from non-exchange transactions recognised in the accounts, for example, seconded staff, use of property, external audit fees, etc.

105. **Auditors should**

- confirm that the charity has followed the requirements of SORP paragraph 6.31 in 2017/18
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

8 Grant expenditure

Purpose of section

106. This section provides information on, and guidance on the risks of misstatement in, grant expenditure.

Definition

107. A grant is a voluntary payment made by a charity to further the purposes of the charity to either a person or an institution.

Summary of proper accounting practices

108. Module 16 of the charities SORP sets out the requirements for the disclosure of grant-making activities.

Risks of misstatement

109. The following paragraphs highlight potential risks of misstatement in respect of grant expenditure, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Grant payments are not identified

110. **Auditors should** assess whether all grants made by a charity during 2017/18 have been properly included under the heading of 'expenditure on charitable activities' in the SoFA.

111. Grants are payments made
- to either a person or an institution
- with the objective of furthering the purposes of the charity
- for which the charity does not receive goods or services of equal value in exchange.

Information on grant-making activities is not properly disclosed

112. SORP paragraph 16.13 requires the following information to be disclosed in the notes
- The total amount of grants paid analysed between grants to individuals and grants to institutions.
- An analysis of the total amount of grants paid by nature or type of activity or project being supported.
- The amount of support costs allocated to grant-making activities.

113. Information provided in relation to grant-making need not be disclosed where

- grants are made to individuals, in which case details of the recipient are not required (except those grants made to related parties - explained in section 10)
- the grant-making activities in total are not material in the context of a charity's overall charitable activities
- total grants to a particular institution are not material in the context of institutional grants, in which case the name of the recipient institution need not be disclosed
- disclosure could result in serious prejudice to the charity or the recipient.

114. Grants to individuals are those made for the direct benefit of the individual who receives it, e.g. to relieve financial hardship or as an educational bursary. All other grants are grants to institutions. In most cases the distinction will be clear. However, a grant which is made to an individual to carry out a research project should be regarded as a grant to the institution to which the individual is connected rather than as a grant to the individual undertaking the research.

115. **Auditors should**

- confirm that the charity has followed the requirements of SORP paragraph 16.13 in 2017/18
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

Grant commitments are not properly accounted for

116. The award of a grant by a charity does not create a contractual relationship with the recipient. However, a liability should be recognised if the charity has no realistic alternative to settling an obligation resulting from a commitment it has made (i.e. constructive obligation). **Auditors should** assess whether a commitment to award a grant in existence at 31 March 2018 has been recognised as a liability when, and only when

- the criteria for a constructive obligation are met
- payment is probable
- it can be measured reliably
- there are no conditions attaching to its payment that limit its recognition.

117. When making this assessment, evidence of a constructive obligation exists where

- the commitment made by the charity is specific, e.g. a promise is made to provide particular grant funding
- the commitment is communicated directly to particular grant recipients
- there is an established pattern of practice that indicates to the recipients that the charity will meet its commitment.

118. Funding commitments can be made which give the charity the discretion to avoid future expenditure based on their assessment of whether the conditions attached to the commitment will be met by the recipient. Where a condition remains within the control of the charity, it

retains the discretion to avoid the expenditure and therefore a liability should not be recognised.

Information on funding commitments is not properly presented and disclosed

119. Charities SORP paragraph 7.43 requires a charity to

- present an analysis of the expenditure resulting from recognised funding commitments across the appropriate headings in the SoFA
- disclose a reconciliation of the movements in funding commitments
- provide a brief description of the nature of the commitment made and the expected amount and timing of any resulting payments.

120. **Auditors should**

- confirm that the charity has followed the requirements of SORP paragraph 7.43 in 2017/18
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

Information on unrecognised grant commitments is not properly disclosed

121. Where a grant offer has been made by the charity but there is uncertainty as to whether the recipient will be able to proceed with its proposal, a liability for the commitment should not be recognised.

122. **Auditors should** assess whether the charity has disclosed the existence of any unrecognised grant commitments at 31 March 2018 as a contingent liability including an explanation of how these will be funded.

9 Combinations and winding ups

Purpose of section

123. This section provides information on, and guidance on the risks of misstatement in, charity combinations and winding ups.

Definition and explanation

124. Chapter 5 of the 2005 Act provides for the reorganisation of charities which includes amalgamation or winding up.

125. A charity merger involves two or more charities combining, usually through the creation of a new charity. No party obtains control over any other, or is otherwise seen to be dominant.

126. The winding up of one charity may involve its assets being gifted to another charity.

Summary of proper accounting practices

127. Paragraphs 19.27 to 19.33 of FRS 102 cover merger accounting.

128. Module 27 of the charities SORP applies to charities that have combined and meet the criteria for merger accounting.

Sources of guidance on proper accounting practices

129. OSCR has provided guidance on the reorganisation of charities.

Risks of misstatement

130. The following paragraphs highlight potential risks of misstatement in respect of combinations and winding ups, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

The combination or wind up is not properly accounted for

131. There are generally three options when accounting for the combination of charities, and these are summarised in the following table:

Option	Explanation
Merger	Merger accounting is appropriate when three criteria are met (summarised in the next table).
Gift	This occurs when one charity is wound up and its assets and liabilities are transferred at nil consideration into the control of another charity in effect as a gift.
Acquisition	If the combination is neither in substance a gift nor a merger, it must be accounted for as an acquisition with any negative goodwill written off in the reporting period of acquisition. This would result in one charity being the subsidiary of the other which would require the latter to prepare group accounts. These would be very rare in the local authority sector.

132. The criteria for a combination to be accounted for as a merger (all of which must be met) are summarised in the following table:

Criteria	Explanation
No party is acquirer or acquiree	No party to the combination should be portrayed as either acquirer or acquiree, either by its governing body or management or by another party to the combination.
All parties participate in establishing the new management structure	All parties to the combination, as represented by the members of the governing body, should participate in establishing the management structure of the new charity. Such decisions are made on the basis of a consensus between the parties to the combination, rather than purely by exercising voting rights.
No significant change to beneficiaries or purpose	There should be no significant change to the class of beneficiaries of the combining charities or the purpose of the benefits provided as a result of the combination. When charities combine, their purposes must be concurrent and the purposes of the new charity must encompass those of the combining charities. While a merger may result in some changes to how activities are carried out, or some minor changes to purposes, a significant change in purposes or the beneficiary class would rule out accounting for the combination using merging accounting.

133. **Auditors should** assess whether any combination of charities, or the winding up of a charity, during 2017/18 have been accounted for on the correct basis.

Gifts from a wound up charity are not properly accounted for

134. The transfer of assets and liabilities from a wound up charity to another section 106 charity requires the assets to be measured at fair value by the receiving charity. The required accounting is summarised in the following table:

Difference between fair value	Accounting treatment
Fair value of the assets received exceeds the fair value of the liabilities assumed	Recognise difference as gain Present separately within income normally as a gift (donation)
Fair value of liabilities assumed exceed the fair value of the assets acquired	Recognise difference as loss Present separately in charitable expenditure

135. **Auditors should**

- confirm that a fair value has been estimated by the receiving charity for any assets and liabilities transferred during 2017/18
- assess whether the estimate of fair value is reasonable
- assess whether the difference between the fair value of assets and the fair value of liabilities has been properly recognised and is free from misstatement.

Mergers are not properly accounted for

136. Where the merger criteria are met, the combination of charities should be accounted for on a merger accounting basis. The main issues around merger accounting are summarised in the following table:

Issue	Explanation
Aggregation of assets, liabilities and funds	The assets, liabilities and funds of the combining charities are aggregated and presented as though they had always been part of the same reporting charity.
Merger reflected from start of year regardless of date merger takes place	Where a merger has taken place during 2017/18, the accounts should reflect the results of the combining charities from 1 April 2017.
Comparative information	The accounts should disclose comparative amounts to show the aggregated results for the combining charities for 2016/17, and should be described as being 'combined' figures.
Valuation	Assets and liabilities of the combining charities should be aggregated at their carrying amounts at the date of the merger and should **not** be restated to fair value.

Issue	Explanation
Accounting policies	Adjustments may be necessary to ensure uniformity of accounting policies.
Restricted funds	Any funds of the amalgamating charities that are restricted to the particular purposes of the new charity should continued to be presented as ‘restricted’ in the accounts of the new charity.
Unrestricted funds	The unrestricted funds of the amalgamating charities should be aggregated provided that their purposes are identical to the new charity.

137. **Auditors should** assess whether any mergers during 2017/18 have been accounted for in accordance with the above table.

Information on mergers is not properly disclosed

138. SORP paragraph 27.14 requires the new charity created after a merger to disclose

- the names and descriptions of the amalgamating charities
- the date of the merger
- an analysis of the principal components of the 2017/18 SoFA to indicate
  - the amounts relating to the new charity for the period after the date of the merger
  - the amounts relating to each party to the merger up to the date of the merger.
- an analysis of the principal components of the 2016/17 SoFA between each party to the merger
- the aggregate carrying amount of the net assets of each party to the merger, differentiating between restricted and unrestricted funds at the date of the merger
- the nature and amount of any significant adjustments made in order to align accounting policies, and an explanation of any further adjustments to net assets as a result of the merger (for example any restatement of unrestricted funds).

139. **Auditors should**

- confirm that any new charity created from a merger during 2017/18 has met the disclosure requirements of SORP paragraph 27.14
- assess whether the disclosures are complete, clear, concise and free from misstatement.

10 Miscellaneous disclosures

Purpose of section

140. This section provides information on, and guidance on risks of misstatement in, the following disclosures

- Disclosures as a subsidiary.
- Related parties.
- Trustees' remuneration.
- Auditor's remuneration.

Summary of proper accounting practices

141. Module 26 applies to charities that are treated as a subsidiary in the accounts of another entity.

142. Related party disclosures are dealt with in section 33 of FRS 102 and module 9 of the charities SORP.

143. SORP module 9 sets out disclosure requirements for trustee's and auditor's remuneration.

Risks of misstatement

144. The following paragraphs highlight potential risks of misstatement in respect of miscellaneous disclosures, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Information on the charity being a subsidiary is not properly disclosed

145. Charities SORP paragraph 26.1 clarifies that when a body acts as a charity's corporate trustee or appoints a charity's trustees, the charity is a subsidiary because it is being 'controlled' by that body through the trusteeship arrangements. A section 106 charity is controlled by the administering authority and is expected to be included in its group financial statements as a subsidiary (explained in module 6).

146. **Auditors should** check that, in accordance with SORP paragraphs 26.5 and 26.6, a charity that is a subsidiary has disclosed in its own accounts

- the name of its parent entity, i.e. the name of the administering authority
- if unincorporated, the address of its parent's place of business
- the address from which the public can obtain the group financial statements that include the subsidiary charity.

- the administering authority's principal purposes and activities
- how control can be exercised by the authority, for example, through corporate trusteeship or through a power to appoint or remove the majority of trustees.

Information on related parties is not properly disclosed

147. The charities SORP requires all transactions between a charity and a related party to be disclosed (subject to specified exemptions). Related parties include a charity's trustees and their close family members and those entities which they either control or in which they have a significant interest. The SORP extends the definition provided in the FRS 102 to include all persons and institutions that are deemed to be connected with a charity or a trustee in charity law.

148. **Auditors should** assess whether the charity has disclosed in the 2017/18 statement of accounts in accordance with SORP paragraph 9.20

- the names of the transacting related parties
- a description of the relationship between the parties
- a description of the transactions
- the amounts involved
- any other elements of the transactions necessary for an understanding of the accounts
- the amounts due to or from related parties at 31 March 2018 and provisions for doubtful debts due from such parties at that date
- amounts written off during 2017/18 in respect of debts due to or from related parties.

149. SORP paragraph 9.18 lists transactions involving trustees or other related parties that need not be disclosed unless there is evidence to indicate that they have influenced the charity's activities or use of resources.

150. If there have been no related party transactions in 2017/18 that require disclosure, **auditors should** confirm that, in accordance with SORP paragraph 9.19, this fact has been disclosed.

Information on trustees' remuneration has not been properly disclosed

151. Charities SORP paragraph 9.6 requires charities to disclose whether the trustees were paid any remuneration or received any other benefits from an employment with their charity or a related entity.

152. **Auditors should** confirm that the charity had disclosed either

- a statement that none of the trustees have been paid any relevant remuneration or received any other benefits; or
- that one or more of the trustees has been paid remuneration or has received other benefits. Auditors should confirm that the charity has also disclosed the information set out at SORP paragraph 9.7 and assess whether the disclosure is free from misstatement.

Information on trustee's expenses has not been properly disclosed

153. Charities SORP paragraph 9.11 requires charities to disclose whether the trustees were reimbursed expenses incurred in carrying out their duties or whether similar payments were made by the charity direct to third parties on their behalf.

154. **Auditors should** confirm that the charity had disclosed either

- that no trustee expenses have been incurred; or
- that one or more of the trustees has claimed expenses or had their expenses met by the charity. Auditors should confirm that the charity has also disclosed the information set out at SORP paragraph 9.12 and assess whether the disclosures are free from misstatement.

Information on auditor's remuneration has not been properly disclosed

155. **Auditors should** confirm that the charity has followed SORP paragraph 9.23 and disclosed the fees payable for the statutory audit.

156. This requirement applies even where the fee was absorbed by the administering authority (as explained in section 7).

11 Financial statements - receipts and payments basis

Purpose of section

157. The purpose of this section is to provide information on, and guidance on the risks of misstatement in, financial statements prepared on a receipts and payments basis.

Summary of proper accounting practices

158. Regulation 9 of the charity regulations covers receipts and payments accounts. Charities can prepare their financial statements on a receipts and payments basis if an accrued basis is not required.

159. Schedule 3 of the charity regulations sets out the information that a statement of account prepared on a receipts and payments basis should contain.

Risks of misstatement

160. The following paragraphs highlight potential risks of misstatement in respect of financial statements prepared on a receipts and payments basis, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

A receipts and payments basis is not properly followed

161. Receipts and payments accounts are created using a simple form of accounting that summarises all monies received and paid via the bank and in cash by the charity during its financial year, along with a statement of balances (instead of a balance sheet).

162. **Auditors should** assess whether financial statements that purport to be on a receipts and payments basis only reflect cash movements. In particular, **auditors should** confirm that

- no adjustments have been made for the timing of income or payments to bring them in line with the activities to which they relate
- the purchase or sale of assets for cash has been included in the statement of receipts and payments. Assets owned by the charity should be shown separately on the statement of balances
- changes in the value of assets have not been reflected.

163. Financial statements prepared on a receipts and payments basis are not intended to give a true and fair view. Financial reporting standards which are primarily concerned with ensuring that financial statements show a true and fair view of a charity's financial affairs do not apply

to receipts and payments accounts. Auditors should check that accounts prepared on a receipts and payments basis do not contain any narrative statements that indicate that the financial statements give a true and fair view.

Statement of receipts and payments is not properly presented

164. The statement of receipts and payments provides an analysis of the incoming and outgoing cash and bank transactions for the year. The requirements for a statement of receipts and payments are set out at Part 1 of Schedule 3 to the charity Regulations. **Auditors should** assess whether the 2017/18 statement shows the following categories separately

- receipts, including donations, legacies and grants
- proceeds from the sale of fixed assets and investments
- payments, including investment management costs, grants and governance costs
- purchase of fixed assets and investments.

165. **Auditors should** assess whether the statement of receipts and payments distinguishes between unrestricted funds, restricted funds, and endowment funds (analysed between expendable and permanent endowment funds). This is usually achieved by giving each fund a separate column in the statement.

166. Where a charity has more than one fund in any of these categories, **auditors should** confirm that

- it has presented the total funds held in each fund
- the notes to the accounts explain in sufficient detail the content of the unrestricted, restricted and endowment funds.

167. **Auditors should** confirm that any transfers from a restricted, unrestricted, expendable endowment or permanent endowment fund into another fund have been shown separately from the receipts and payments.

Statement of balances is not properly presented

168. The requirements for a statement of balances are set out at Part 1 of Schedule 3. **Auditors should** assess whether the statement of balances at 31 March 2018

- distinguishes between unrestricted, restricted, expendable endowment or permanent endowment funds
- reconciles the cash and bank balances at 1 April 2017 and 31 March 2018 with the surplus or deficit shown by the receipts and payments account
- summarises the holding of investments and market valuation
- summarises other assets including gifted assets and states the cost or a valuation of the assets (a valuation is required where the charity trustees consider it to be lower than cost)

- states an estimate of the liabilities at 31 March 2018 (e.g. the audit fee but only where payable by the charity) showing separately any contingent liabilities
- has been signed by a charity trustee on behalf of all the charity trustees
- specifies the date on which the statement of account was approved by the charity trustees.

Information in the notes has not been properly disclosed

169. Part 2 of Schedule 3 requires the following additional information to be disclosed in the notes to the accounts

- The nature and purpose of each fund held by the charity, including any restrictions on their use.
- The number and amount of any grants paid out by the charity, the type of activity or project supported by those grants, and whether they were paid out to an individual or an organisation.
- The amount of remuneration paid to a charity trustee or person connected to a charity trustee (a connected person). Any remuneration must be in accordance with section 67 of the 2005 Act and the note must specify the authority under which the remuneration was paid. If no remuneration was paid to a charity trustee or anyone connected to a charity trustee this must be stated.
- The total amount of expenses, if any, paid to charity trustees and the number of charity trustees receiving expenses. If no expenses were paid to charity trustees this must be stated.
- The nature of any transactions between the charity and any charity trustee or person connected to a charity trustee. This may include, for example, a charity trustee purchasing an asset from the charity or a charity paying a firm for services such as professional advice where a charity trustee has a substantial interest in the firm. This note must include
  - the nature of the relationship
  - the nature and amount of the transaction
  - any outstanding balance at the financial year end.
- Any further information required to reasonably assist the reader to understand the statement of accounts.

170. **Auditors should**

- confirm that the charity complies with part 2 of Schedule 3
- assess whether the disclosures are complete, clear, concise and free from misstatement.

Statement on accounting policies is not included

171. There is also no explicit requirement for a statement setting out the accounting policies. Although in the context of receipts and payments accounts it would be brief, it is recommended that such a statement be included in the statement of accounts.

172. **Auditors should** encourage the charity to include a statement of accounting policies in the 2017/18 statement of accounts.

12 Trustees' annual report

Purpose of section

173. This section of the module provides guidance on auditors' responsibilities for, and the risks of material misstatement in, the trustees' annual report. It also sets out test procedures for auditors to carry out.

Definition

174. The trustees' annual report is a narrative statement from the trustees which the charity regulations require to be included with the statement of accounts. It is the charity equivalent of a local authority's management commentary.

Summary of proper accounting practices

175. Module 1 of the charities SORP sets out the requirements for the trustees' annual report for accounts on an accruals basis

- The required contents for smaller charities are set out at SORP paragraphs 1.14 to 1.32.
- The additional content for larger charities is set out at SORP paragraphs 1.34 to 1.53.

176. Schedule 2 of the charity regulations set out the requirements for accounts prepared on a receipts and payments basis.

Summary of auditors' responsibilities

177. Auditors' responsibilities for a trustees' annual report are the same as for a local authority's management commentary (explained in module 8).

178. The test procedures that auditors should undertake to meet the above responsibilities are set out throughout this section and are summarised in Appendix 3.

179. The model independent auditor's report for 2017/18 will be provided in a separate technical guidance note and will include wording for the trustees annual report opinions.

Risks of misstatement

180. The following paragraphs highlight potential risks of misstatement in the trustees' annual report, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Trustees' annual report is not consistent with the financial statements

181. Auditors should perform procedures necessary to identify any material inconsistencies between information in the trustees' annual report and the financial statements.

Test procedure 1 - inconsistencies with financial statements

Auditors should

- **select amounts or other items in the trustees' annual report and compare them with the corresponding amounts or other items in the financial statements**
- **conclude whether an inconsistency means there is a misstatement**
- **request that any misstatements be corrected**
- **discuss any uncorrected material misstatement in the trustees' annual report with Audit Scotland**
- **report in the independent auditor's report**

182. The trustees' annual report may include amounts or other items that are intended to be the same as, to summarise, or to provide greater detail about, the amounts or other items in the financial statements. Examples of such amounts or other items may include

- tables, charts or graphs containing extracts of the financial statements
- disclosure providing greater detail about an item shown in the financial statements
- descriptions of the financial results.

183. In order to evaluate their consistency, auditors should select amounts or other items in the trustees' annual report and compare them with the corresponding amounts or other items in the financial statements. Auditors are not required to compare all amounts or other items in the trustees' annual report that relate to the financial statements. When making the selection, auditors should consider

- the significance of the amount or other item in the context in which it is presented, which may affect the importance that users would attach to the amount or other item (e.g. a key ratio or amount)
- the relative size of the amount compared with amounts or items in the financial statements or the trustees' annual report to which they relate
- the sensitivity of the particular amount or other item in the trustees' annual report.

184. When checking the consistency of the selected items, auditors should

- for information that is intended to be the same as information in the financial statements, compare the information to the financial statements
- obtain a reconciliation between an amount within the trustees' annual report and the financial statements and
  - compare items in the reconciliation to the financial statements and the trustees' annual report; and
  - check whether the calculations within the reconciliation are arithmetically accurate.

- for information intended to convey the same meaning as disclosures in the financial statements, compare the words used and consider the significance of differences in wording used and whether such differences imply different meanings.

185. If auditors identify an inconsistency between information in the trustees' annual report and the financial statements, auditors should
    - conclude whether there is a misstatement in the trustees' annual report
    - conclude whether there is a misstatement in the financial statements
    - request that the authority corrects any misstatement identified.

186. Further guidance on cases where a material misstatement in the trustees' annual report is not corrected will be provided in the technical guidance note on independent auditor's reports, but in summary auditors should
    - discuss the matter with Audit Scotland's Professional Support
    - describe the material misstatement in the independent auditors report
    - qualify their opinion on the trustees' annual report in respect of consistency with the financial statements.

Trustees' annual report is not in accordance with applicable requirements

187. Auditors should perform procedures necessary to conclude as to whether the trustees' annual report has been prepared in accordance with proper accounting practices (i.e. the charities SORP in respect of accounts on an accrued basis, and schedule 2 of the charity regulations in respect of receipts and payments accounts).

Test procedure 2 - non-compliance with proper accounting practices

Auditors should

- **use the checklist at Appendix 4 to assess whether information required by proper accounting practices has been omitted from the trustees' annual report**
- **request that any misstatements be corrected**
- **discuss any uncorrected material misstatement in the trustees' annual report with Audit Scotland**
- **report in the independent auditor's report**

188. Auditors should assess whether information required by proper accounting practices to be included in the trustees' annual report has been omitted. This includes situations where required information has been presented separately without appropriate cross-reference.

189. The report is required to
    - provide a fair, balanced and understandable review of the charity's structure, legal purposes, objectives, activities, financial performance and financial position

- identify the reporting period to which it relates and the date of its approval. One or more of the charity’s trustees must sign and date the report on behalf of the trustees upon their approval of the report.

190. The required contents for smaller charities are set out at paragraphs 1.14 to 1.32 of the charities SORP. Smaller charities are described by SORP paragraph 1.8 as those not subject to statutory audit under charity law. As the audit requirement for section 106 charities derives from the 1973 Act rather than the monetary limits in the charity regulations, the view of Audit Scotland's Professional Support is that they may be treated as smaller charities. In order to assess whether required information has been omitted, auditors should check whether the trustees' annual report includes the items summarised at appendix 4 to this module.

191. Smaller charities are encouraged (but not required) to include some or all of the additional information required of larger charities if the charity trustees consider such additional information relevant to their charity’s stakeholders. The additional content for larger charities is set out at SORP paragraphs 1.34 to 1.53.

192. Schedule 2 of the charity regulations set out the requirements for accounts prepared on a receipts and payments basis.

Trustees' annual report is inconsistent with auditor's knowledge

193. Auditors should perform procedures necessary to identify any material inconsistencies between information in the trustees' annual report and their knowledge obtained in the audit.

Test procedure 3 - inconsistency with auditor's knowledge

Auditors should

- **consider whether there is a material inconsistency between the trustees' annual report and the knowledge they have obtained in performing the audit**
- **request that any misstatements be corrected**
- **discuss any uncorrected material misstatement in the trustees' annual report with Audit Scotland**
- **report in the independent auditor's report**

194. The trustees' annual report may be consistent with the financial statements and be prepared in accordance with the applicable requirements, but may still be inconsistent with the auditor’s knowledge acquired in the course of performing the audit. ISA (UK) 720 requires auditors to consider whether there is a material inconsistency between the trustees' annual report and the auditor's knowledge obtained in the audit. The auditor’s knowledge obtained in the audit includes the auditor’s understanding of the charity and its environment.

195. In considering whether there is a material inconsistency between the trustees' annual report and the auditor’s knowledge obtained in the audit, auditors may focus on those matters that are of sufficient importance that a misstatement in relation to that matter could be material.

196. If auditors identify a material inconsistency between information in the trustees' annual report and their knowledge, auditors should

- conclude whether there is a misstatement in the trustees' annual report
- consider whether their understanding of the charity and its environment needs to be updated
- request the charity to correct any misstatement identified.

197. Further guidance on cases where a material misstatement in the trustees' annual report is not corrected will be provided in the technical guidance note on independent auditor's reports, but in summary auditors should

- discuss the matter with Audit Scotland's Professional Support
- describe the material misstatement in the independent auditors report.

Information in the trustees' annual report is misleading

Test procedure 4 - misleading information

Auditors should

- **consider whether any information in the trustees' annual report is misleading**
- **request that any misstatements be corrected**
- **discuss any uncorrected material misstatement in the trustees' annual report with Audit Scotland**
- **report in the independent auditor's report**

198. A misstatement in the trustees' annual report can also exist when the information is misleading. This includes situations where it omits or obscures information necessary for a proper understanding of a matter disclosed in the trustees' annual report.

199. When reading the trustees' annual report, auditors should remain alert for instances where the information is misleading.

200. If auditors identify any information in the trustees' annual report that is misleading, auditors should

- conclude whether there is a misstatement in the trustees' annual report
- request the local authority to correct any misstatement identified.

201. Further guidance on cases where a material misstatement in the trustees' annual report is not corrected will be provided in the technical guidance note on independent auditor's reports, but in summary auditors should

- discuss the matter with Audit Scotland's Professional Support
- describe the material misstatement in the independent auditors report.

Trustees' annual report is not properly signed

202. Auditors should confirm that the trustees' annual report has been signed by one or more of the charity's trustees.

Appendix 1

Number of section 106 charities

Council	2013/14	2014/15	2015/16	2016/17	Progress in reducing numbers since 2013/14
City of Glasgow	0	0	0	0	N/A
Midlothian	0	0	0	0	
Western Isles	0	0	0	0	
Inverclyde	3	2	0	0	3 fewer
East Lothian	1	1	1	1	N/A
Falkirk	1	1	1	1	
Shetland	1	1	1	1	
Orkney	2	2	1	1	1 fewer
City of Edinburgh	8	7	7	7	1 fewer (but no progress since 2014/15)
Perth & Kinross	28	26	22	19	9 fewer
Moray	38	38	38	38	No progress
West Dunbartonshire.	3	3	2	2	1 fewer since 2013/14
Fife	50	50	48	48	2 fewer
Aberdeen	8	8	8	8	No progress
Clackmannanshire	5	5	4	4	1 fewer
Dumfries & Galloway	55	55	28	8	47 fewer
Dundee	29	30	30	28	1 fewer
West Lothian	13	13	14	14	1 more
Aberdeenshire	39	39	5	5	34 fewer
Renfrewshire	5	7	7	7	2 more
Stirling	21	21	21	21	No progress
Angus	1	2	2	2	1 more since 2013/14

Council	2013/14	2014/15	2015/16	2016/17	Progress in reducing numbers since 2013/14
East Ayrshire	7	8	7	4	3 fewer
Argyll & Bute	11	10	9	8	3 fewer
East Dunbartonshire	7	7	7	5	2 fewer
East Renfrewshire	7	7	7	7	No progress
Highland	2	2	2	2	No progress
North Ayrshire	12	12	10	10	2 fewer
Scottish Borders	2	7	7	7	5 more
South Ayrshire	9	9	9	3	6 fewer
South Lanarkshire	3	3	3	3	No progress
North Lanarkshire	13	13	6	6	7 fewer
TOTALs	**384**	**389**	**307**	**270**	114 fewer (37 since previous year)

Appendix 2

Number of section 106 charities statements of account

Council	2013/14	2014/15	2015/16	2016/17	Scope for further application of connected charities provisions
City of Glasgow	0	0	0	0	Connected charities provisions not applicable
Midlothian	0	0	0	0	
Western Isles	0	0	0	0	
Inverclyde	3	2	0	0	
East Lothian	1	1	1	1	
Falkirk	1	1	1	1	
Shetland	1	1	1	1	
Orkney	2	2	1	1	
City of Edinburgh	1	1	1	1	Connected charities provisions applied and the affect was one set of accounts
Perth & Kinross	1	1	1	1	
Moray	1	1	1	1	
West Dunbartonshire.	1	1	1	1	
Fife	1	1	1	1	
Aberdeen	4	1	1	1	
Clackmannanshire	1	1	1	1	
Dumfries & Galloway	4	4	2	2	Connected charities provisions applied to reduce the number of sets of accounts to a minimum – there appears no further scope for use
Dundee	2	2	2	2	
West Lothian	8	8	9	9	
Aberdeenshire	13	13	5	5	

Council	2013/14	2014/15	2015/16	2016/17	Scope for further application of connected charities provisions
Renfrewshire	2	2	2	2	Connected charities provisions applied and effect reduced the number of sets of accounts but ‘common trustees’ provides scope for further use
Stirling	4	4	3	3	
Angus	1	2	2	2	Connected charities provisions not applied but no apparent scope to do so due to different trustees
East Ayrshire	7	8	7	4	
Argyll & Bute	11	10	9	8	Connected charities provisions not applied but ‘common trustees’ appears to provide scope to do so
East Dunbartonshire	7	7	7	5	
East Renfrewshire	7	7	7	7	
Highland	2	2	2	2	
North Ayrshire	12	12	10	10	
Scottish Borders	2	7	7	7	
South Ayrshire	9	9	9	3	
South Lanarkshire	3	3	3	3	
North Lanarkshire	13	13	6	6	Connected charities provisions not applied though ‘common trustees’ appears to provide scope to do so (although 5 of the separate accounts were collated into a single document)
TOTALs	**125**	**127**	**103**	**91**	34 fewer since 2013/14

Appendix 3

Auditor action checklist - trustees' annual report

Test procedures	Yes/No/N/A	Initials/date	W/P ref
1 Have you • selected amounts or other items in the trustees' annual report and compared them with the corresponding amounts or other items in the financial statements? • concluded whether an inconsistency with the financial statements means there is a misstatement in the trustees' annual report? • requested that any misstatement be corrected?			
2 Have you • used the checklist at Appendix 4 to assess whether information required by the applicable requirements has been omitted from the trustees' annual report? • requested that any misstatements be corrected?			
3 Have you • considered whether there is a material inconsistency between the trustees' annual report and the knowledge you have obtained in performing the audit? • requested that any misstatements be corrected?			
4 Have you • considered whether any information in the trustees' annual report is misleading? • requested that any misstatements be corrected?			
5 Have you discussed any uncorrected material misstatement in the trustees' annual report with Audit Scotland's Professional Support?			

Appendix 4

Checklist - required content of trustees' annual report

Required item	Yes/No/N/A
1 A summary of the purposes of the charity as set out in its governing document; and the main activities undertaken in relation to those purposes	
2 A summary of the main achievements of the charity	
3 A review of the charity's financial position at the end of the reporting period	
4 Any policy it has for holding reserves, the amounts of those reserves and why they are held. If the trustees have decided that holding reserves is unnecessary, the report must disclose this fact and provide the reasons behind this decision	
5 The identification of any fund that is materially in deficit, with an explanation of the circumstances giving rise to the deficit and the steps being taken to eliminate the deficit	
6 The nature of the governing documents, how the charity is constituted, and the methods used to appoint new trustees	
7 Reference and administrative information including the name of the charity, the names of all those who were the charity's trustees on the date the report was approved or who served as a trustee in the reporting period, and the names of the directors of any corporate trustees on the date the report was approved.	