

Charity Finance Group consultation response

Reporting matters of material significance to a UK charity regulator

September 2016

Introduction

About Charity Finance Group

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

CFG hosts a regular Technical Account Forum which brings together charity experts, auditors and charities to discuss the impact of accounting legislation – as well as other accounting policy and regulatory changes – on their organisations. We also held a special meeting of auditors and accounting professionals at CFG's offices to discuss these changes.

This response draws on the evidence collated in these meetings in addition to working closely with auditors, independent examiners and accountants as well as our experience working with our charity members.

For more information on this response please contact Heather McLoughlin, Policy and Public Affairs Office, on 02078715480 or heather.mcloughlin@cfg.org.uk

Motivation for responding to this consultation

We welcome this review by the Charity Commission, OSCR and CCNI into reporting matters of material significance. Over our many years of working with auditors and charity finance professionals we know that making regulation that benefits the charities and the public trusts is important. Throughout this consultation the word 'auditors' will be used to mean both auditors and independent examiners unless otherwise specified.

We believe that it is vital that any proposed changes work best for charities and their beneficiaries, and advances the public interest rather than the short-term aim of appeasing significant public actors, such as the media.

It is in this spirit that we believe any changes to matters of material significance should be done under with these principles in mind:

1. **Cost** - it is important that the cost of additional reporting by auditors and independent examiners are not transferred to charities.
2. **Pragmatic** - proposals should reflect the reality of running a charity and the capacity of charities to respond to these proposals if introduced.
3. **Maintaining a strong relationship between auditors, independent examiners and charities** - These relationships should be maintained and not be damaged so that the best advice and support is given to charities.

Executive summary

- **We welcome this review into matters of material significance, and believe that it should have the principles of cost, pragmatism and maintaining a strong relationship between auditors and independent examiners at their heart.**
- While we understand the Charity Commissions desire to maintain public trust and confidence, we are concerned that most of the recommendations do not take into account the role and expertise of independent examiners, and believe that matters of material significance need to be set with their role in mind.
- Throughout this consultation auditors will be used to mean both auditors and independent examiners unless otherwise specified.
- We believe that revisions to matters 1 and 2 do not add significant clarification for auditors and independent examiners and should be clarified by changing the terminology in the SORP first, and then making the terminology aligned with matters of material significance.
- The expanded definition to matter 3 is unhelpful and could inadvertently affect charities access to banking services. We recommend greater clarification on the amendments and that the proposal for reporting on using joint bank accounts is removed.
- We propose that 'knowledge' is more concrete and clearer so should be used instead of 'belief' in matter 4.
- The proposed amendments to matters 5 and 7 do not provide any greater clarity for auditors and would result in an undue burden on auditors. We recommend greater clarification about where and when evidence can be gathered by auditors before this amendment is implemented.
- We support the removal of matter 8 to simplify reporting for auditors and charities.
- Greater clarity is needed to the proposed amendment to matter 9 for this proposal to fully work.
- To reduce additional reporting burdens for auditors we recommend the removal of matter 10 and the rewording of matter 2 to include provisions over a failure to address internal controls from previous year's accounts by the charity.
- Matter 11 should not be included as a matter of material significance. As this appears to be an attempt to align matters of material significance with the SORP, it is better to address this matter in the SORP and should not be imposed into matters of material significance.
- **We have concerns that auditors are increasingly being asked to police the charity sector. Greater support and training for charities from the Charity Commission would help to increase standards of compliance.**
- There is a significant risk that the increasing reporting requirements for auditors would be detrimental to building a more financially resilient sector. Auditors would take a step back from working with their clients for fear of the regulatory consequences greatly reducing the avenues through which charities, especially small charities, can receive support.
- **The potential additional reporting requirements could place a disproportionate burden on independent examiners and the charities that use them.** These recommendations do not account for the ability and responsibility of an independent examiner, and are instead solely focused on auditor's capacity.

- **A central area of concern is the potential impact that these recommended reporting requirements could have on the relationship between auditors and their clients.** Trustees and charities rely on open conversations where their auditor will recommend good practice. With an increased reporting obligation for auditors, these open conversations might cease to exist.

Comments on the reporting matters of material significance consultation

The terminology in matters 1 and 2 has been amended to agree to that used in the SORP; do you agree that this is helpful for consistency?

We do not think that matter 1 presents a significant change as there is still no clear definition between material and significant for auditors and independent examiners. As there is no clear definition between material and significant in accountancy legislation, trustees, charities and auditors will have various interpretations. This has led to concern that the terminology used in matter 1 and 2 could be open to subjectivity leading to a potential lack of confidence in accounts.

Furthermore, for matter 2 the change in wording could create uncertainty over whether auditors and independent examiners should look for failures of internal controls from internal audit reports. We think that the use of 'could give rise' is a vague term and could lead to a potential damaging of relationship between auditors and independent examiners and their clients if there was a fear that charities could be reported to the Charity Commission under vague terms.

The proposed amendments do not add greater clarification as the terminology within the SORP is still unclear. We recommend that the suggested terminology in the SORP is changed first and then aligned with matters of material significance.

Do you agree that the expanded definition [in matter 3] is helpful?

We do not agree that the expanded definition is helpful. There are concerns that this reporting requirement for auditors and independent examiners could be illegal and could put the auditor at risk of tipping off. It is unclear whether reporting to the Charity Commission would be considered a tip off. This is particularly pertinent for independent examiners where this level of reporting responsibility might be a burden too far. Current guidance for independent examiners does not include guidance on reporting on suspected money laundering activity.

We also think that there needs to be greater clarification of the role of the Money Laundering Reporting Officer (MLRO) with regards to reporting money laundering issues. We are

concerned that there is a little clarification about what the Commission would expect from a MLRO if an auditor was required to report this.

We have concerns about the introduction of 'charities allowing others to use their bank account to move money'. We do not feel that this adds anything to the auditing process and that it might deter charities from sharing financial services which is becoming increasingly important as a way to reduce costs, improve effectiveness and pool risk.

We believe that the expanded definition is unhelpful and could inadvertently affect charities access to banking services. We recommend greater clarification on the amendments and that the proposal for reporting on using joint bank accounts is removed.

Do you agree that the matter should be expanded in this way? Do you consider that the proposed wording is appropriate?

We support the proposed amendment that 'knowledge' is used instead of 'belief' as 'knowledge' is more concrete and clearer. While an auditor can use both, preference is always given to 'knowledge' over 'belief'. This is because it is more concrete. 'knowledge' must be derived from the objective facts and evidence available to an auditor in the circumstances they are in. We are happy with the matter 4 to align Northern Ireland with the Charity Commission and OSCR.

If the above was acted upon, we would support this proposal.

Concerns over changes to Matter 5 and Matter 7

Matters 5 and 7 do not provide any greater clarity for auditors and independent examiners. When we consulted accounting experts there was a clear consensus that the changes to the wordings of matter 5 and 7 were unclear, with specific reference to 'evidence would be obtained during the audit/independent examination'. We believe that the wording is too vague about whether this evidence would be from all conversation between auditors and their clients or if it should evidence gained from internal audits.

Currently legislation states that evidence can be gained from anything, but the changes proposed in matters 5 and 7 adds greater confusion as it does not bring any additional clarity. We also raise concern about the effectiveness of auditors reporting the same information to the Charity Commission when they are aware that the charity has reported it as it was felt that the Charity Commission just need to be informed once of a matter of material significance. We believe this would increase auditor costs (ultimately being paid for by the charity) and could damage the relationship between auditors and their clients. Overall, it was felt among the experts that this amendment does not bring any benefit.

Additionally, for matter 7 it was felt that 'significant charitable assets or liabilities' should be changed to 'material charitable assets or liabilities' as this would conform to established wording.

The proposed amendments to matters 5 and 7 do not provide any greater clarity and would result in an undue burden on auditors and independent examiners. We recommend greater clarification about where and when evidence can be gathered by auditors before this amendment is implemented.

Do you agree that [matter 8] should be removed?

We support the removal of matter 8. We deem it to be a move to simplify reporting for auditors and charities. We also believe that this reporting requirement was surplus as the reporting of relevant information is covered in other areas of the document.

We support the removal of matter 8.

Do you agree that the inclusion of this within the matter [9] of material significance will assist auditors and independent examiners?

We has concerns about the logistics of how implementing this matter for auditors, independent examiners and charities would work in practice as there we have concerns about reporting on continuing matters. It is unclear if an auditor should delay a modified report till attempts have been made to resolve the problem by the charity and/or trustees.

We also question what capacity the Charity Commission has to review modified reports from auditors and independent examiners. If there was a lack of capacity among the Charity Commission to act on these reports then it is a waste of both charities and auditors time. Even if there is a capacity to act on these reports, we believe that it would seriously undermine the relationship between auditors and charities. Moreover, a disproportionate burden would be placed on auditors and independent examiners to correspond between the Charity Commission and trustees. This would increase costs for auditors, which would be transferred to their clients and the Charity Commission has not outlined what improvements there would be for the sector to justify the significant increase in cost. We believe that once an auditor has provided a modified report and has notified the Charity Commission that any further responsibility to monitor the charity should be done by the Commission.

This matter also raises concerns about the auditors' role in regulating charities. We are concerned that this proposed matter has been introduced primarily due to the closure of Kids Company. It is not the responsibility of auditors to regulate charities and that the Commission needs to be careful about undermining the relationship and trust between auditors and charities, as auditors will be seen as merely an enforcement arm of the Commission.

We do not support the inclusion of this proposal.

Do you agree that this matter [10] should be included as a reportable matter?

We have numerous concerns about the proposed introduction of matter 10. We feel that this is a misuse of management letters on numerous fronts. Firstly, management letters are confidential between the charity and the auditor and this matter is unclear in whether that confidentiality will be maintained.

We have further concern over confidentiality of management letters when a charity changes auditors as there is no legal obligation for an auditor to release management letters. This is exacerbated by the lack of a concrete time frame for the scrutiny of accounts. Additionally, for independent examiners the issue of management letters would not be common as most would communicate concern verbally. Again, this raises fears for a greater burden on independent examiners and may increase the cost of these services for smaller organisations. No cost/benefit analysis has been given for why the increase in cost is justifiable.

The introduction of matter 10 could lead to a parallel reporting framework with 'management letters' being issued to meet regulatory expectations but with other forms of communication replacing management letters role in raising concerns as well as giving advice for charities on how to improve their operations. This could end up creating unnecessary bureaucracy and duplication and undermining the intention of this change, which is to give the Charity Commission a more accurate assessment of the operations of the sector.

While we can see the benefit of merging regulator standards with that of the housing and education sector, where management letters would be sent to the regulator, there appears to be little clarification in the proposed framework. Furthermore, other regulators do not require auditors to identify and report if their clients have not followed the recommendations in a management letter.

Again, this additional reporting requirement raises concern on whether the trust between auditors, independent examiners and their clients would be maintained under the new proposals.

We would recommend the removal of matter 10 and rewording of matter 2 to include provisions over a failure to address internal controls from previous year's accounts by the charity. This would allow trust to be maintained between auditors and their clients and would also reduce the additional reporting burdens for independent examiners.

Do you agree that this matter should be included as a matter of material significance?

We do not agree that matter 11 should be included as a matter of material significance. We question the imposing of responsibility for managing Charity Commission/OSCR regulations on conflict of interests onto auditors.

We have a concern over how the Charity Commission and auditors will be able to enforce this with trustees who refuse to disclose any related party transactions and what legal issues would arise over privacy it could reduce trustees' willingness to serve on the board. With the charity sector already facing a shortage of trustees, matter 11 could inhibit the ability of charities to recruit trustees in the future if they are not willing to accept full disclosure of any potential related transactions.

The matter would create significant extra burden for auditors, and especially independent examiners, with the increased cost of compliance being passed along to charities. Given the potential increases in cost, we question what the Commission would really gain from learning this information and how this information can help the Commission create a financially robust sector.

We believe that as matter 11 is an attempt to align matters of material significance with the SORP we think that this should be addressed in the SORP and not imposed into matters of material significance.

Do you agree that the increased areas identified as matters of material significance aids clarification and is not a significant increase in regulatory burden? If not please provide you reasons for this.

We understand that the Charity Commission is concerned on maintaining public trust and confidence in the sector but we fears that the amendments to the reporting requirements will create significant increase in regulatory burden for charities, auditors and independent examiners.

We have concerns that auditors are increasingly being asked to police the charity sector, which is the role of the Charity Commission. We believe that more support and training for charities would help to increase standards of compliance and lead to greater levels of resilience. **The Charity Commission needs to step up its support and advisory work with charities, and sector bodies, rather than increasing reporting requirements.**

There is a significant risk that increasing reporting requirements for auditors and independent examiners may actually counter the Charity Commission's efforts to build a more financially resilient sector. Our discussions with auditors and independent examiners have highlighted the risk that advisors may take a step back from working with their clients for fear of the regulatory consequences of not reporting on those discussions. Unless this concern is addressed along the lines that we have recommended, the Charity Commission may reduce the number of avenues through which charities, particularly small charities, can receive support.

Furthermore, for independent examiners and the charities that use them, the potential additional reporting requirements could place disproportionate burden. Independent examiners are meant to be an affordable option for small charities and the task is often undertaken by volunteers. Extra regulatory responsibility could potentially reduce the number of independent examiners willing to work for free or at a reduced rate. At a time when charities are also under significant cost pressures, increasing the cost of independent

examinations would not be in the interests of the sector. Moreover, the increased costs may leave charities less able to afford to get other forms of financial advice and support which could strengthen their financial performance and resilience. We are also concerned that most of the recommendations do not account for the ability and responsibility of an independent examiner, and are instead focused on auditor's capacity instead.

As stated throughout this response, a central area of concern is the potential impact that these recommended reporting requirements could have on the relationship between auditors and their clients. A key concern raised to us by auditors and independent examiners is that the relationship between auditors and charities is different to that seen in the for-profit world. Trustees and charities often rely on their auditors for good practice recommendations in open conversations. With an increased burden on auditors to monitor and report more as underlined in this consultation, these open dialogues might cease to exist. This would end up undermining the financial resilience of the sector and have significant negative long term consequences, which we do not believe is the Charity Commission's intention.

We strongly urge caution before implementing changes to reporting requirements of auditors and independent examiners.