Audit of 2018/19 annual accounts (local government) - section 106 charities

Technical guidance note 2018/10(LG) module 13

Prepared for appointed auditors in the local government sector

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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

1 Introduction

Purpose of module

1. This module of technical guidance note 2018/10(LG) provides information on, and guidance on the risks of misstatements in, the following statement of accounts areas of registered charities that fall within section 106 of the *Local Government (Scotland) Act 1973* (section 106 charities):
    - Proper accounting practices (section 3).
    - Fund accounting (section 4).
    - Presentation of financial statements (section 5).
    - Investments (section 6).
    - Donations and legacies (section 7).
    - Grant payments (section 8).
    - Combinations and winding ups (section 9).
    - Disclosures on being a subsidiary, related parties, trustees' remuneration and auditor's remuneration (section 10).
    - Receipts and payments accounts (section 11).
    - Trustees' annual report (section 12).
2. Other areas such as heritage assets may also apply to a section 106 charity, and auditors should refer to the relevant module of the technical guidance note.
3. This module also provides an update on the progress being made in rationalising the number of section 106 charities.

Contact point for this module

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

2 Section 106 charities audit requirement

Explanation of audit requirement

5. 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 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).

6. The audit of the statement of accounts prepared by registered charities is regulated by The Charities Accounts (Scotland) Regulations 2006 (the charity regulations) which 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 section 106 charity's statement of accounts.

7. Appendix 1 shows the 218 section 106 charities in 2017/18 analysed of by local authority. It can be seen that six authorities still had ten or more charities. **Auditors should** assess whether the authority is making reasonable progress in rationalising the number of section 106 charities that it administers.

Summary of auditor's responsibilities

8. 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 Regulation 9 (which provides for the public inspection of the accounts) and Regulation 11 (which requires the publication of the statement of accounts on the local authority's website) of the accounts regulations
- comply with the requirements of the charity regulations
- have been prepared in accordance with proper accounting practices (explained in section 3).

9. Auditors' responsibilities for section 106 charities' 2018/19 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.

10. In addition, under section 46 of the 2005 Act, **auditors must** report to OSCR any matter they become aware of regarding a charity which they believe is likely to be of material significance to OSCR in carrying out its functions. Examples include:

- dishonesty or misuse of funds, e.g. theft or misappropriation of assets by a trustee, misapplication of charitable funds
- a serious breach of the 2005 Act relating to accounts, trustee duties or trustee remuneration
- activities not in pursuit of charitable purposes.

3 Proper accounting practices

Summary of proper accounting practices

11. Section 12 of the 2003 Act requires section 106 charities 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.

12. 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.

External guidance

13. External guidance referred to in this section is Scottish charity accounts - An updated guide to the 2006 regulations from OSCR.

Risks of misstatement

14. 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.

Connected charities provisions are not used

15. Regulation 7 of the charity regulations (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. The overall number of separate sets of statements of accounts that are required for section 106 charities can therefore be reduced by the effective application of the connected charities provisions.

16. There were 77 sets of accounts in 2017/18 (down 14 from 91 in 2016/17). Appendix 1 shows an analysis by authority and indicates the extent to which the connected charities provisions were applied in 2017/18. Seven authorities made no use of the connected charities provisions and a further two only partially applied them. Auditors of the relevant nine local authorities should encourage them to make full use in 2018/19, so that the total number of sets of accounts that requires to be audited is minimised.

The correct accounting basis is not adopted

17. 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.

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

19. 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.

20. **Auditors should** confirm that the charity has prepared accrued financial statements for 2018/19 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

21. The following table provides a summary of requirements of the charity regulations in respect of the content of the statements of accounts:

<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>

22. **Auditors should** confirm that the 2018/19 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 charity includes the missing element where its inclusion is required

- where a charity declines to include the required element, consider the impact on the affected opinion in the independent auditor's report.

Governing documents are not complied with

23. 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.

24. **Auditors should** read the charity's governing documents and assess whether in 2018/19 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

25. 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.

26. 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).

27. 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
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.
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** consider 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 qualified opinion on the basis of limitation of scope would not be necessary.

4 Fund accounting

Summary of proper accounting practices

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

Risks of misstatement

29. 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

30. 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.
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.

31. **Auditors should** assess whether:

- restricted income funds have been spent or applied during 2018/19:
  - 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
- 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 (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 2018/19, 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

32. A transfer may be made between funds, for example to transfer assets from unrestricted funds to finance a deficit on a restricted fund, or where restricted funds have been lawfully released and transferred to unrestricted funds. **Auditors should** confirm that any transfers during 2018/19 have been presented in the transfer line in the SoFA.

Information on funds has not been properly disclosed

33. Charities SORP paragraph 2.28 requires a charity to disclose information on material individual fund balances, movements, and the purposes for which the funds are held. Disclosures should differentiate between unrestricted funds, restricted income funds, permanently endowed funds and expendable endowments. 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. **Auditors should:**

- confirm that the trustees have complied with paragraphs 2.28 and 2.29 of the SORP in 2018/19
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

5 Presentation of accrued financial statements

Summary of proper accounting practices

34. Module 4 of the [charities SORP] sets out the requirements for the SoFA and Module 10 for the balance sheet.

Risks of misstatement

35. 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

36. 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 2018/19
- a balance sheet which shows the state of affairs of the charity as at 31 March 2019
- a cash flow statement, if appropriate
- notes to the accounts

37. **Auditors should** assess whether the charity has:
- presented a complete set of financial statements for 2018/19
- 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 2017/18 for each item presented
- adopted the same format as 2017/18 (or the change is explained in the notes)
- omitted any line where there is nothing to report in 2018/19 and 2017/18.

Statement of financial activities is not properly presented

38. The SoFA is a single accounting statement that should include all income, gains, expenditure and losses recognised for 2018/19. The SoFA provides the user with an analysis of the income and endowment funds received and the expenditure by the charity on its activities, as well as a reconciliation of the movements in a charity's funds for 2018/19.

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

Options	Structure
Activity basis	The structure and headings 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 etc
Accounting records	SORP paragraph 4.6 allows a charity to use the headings it uses to record expenditure in its own accounting records.

40. 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. Where the charity applies this approach, the heading should be changed appropriately (e.g. to 'all unrestricted and restricted funds').

41. **Auditors should** confirm that:

- where an activity basis is used, the SoFA follows 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 applied, the heading has been changed appropriately.

Balance sheet is not properly presented

42. 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 for specific purposes.

43. 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.

44. **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 2017/18 is not comparable due to a change in accounting policy, it has been adjusted and the reason for the adjustment disclosed
- the balance sheet has been signed by one or more authorised trustee
- the balance sheet specifies the date the accounts were approved by the trustee body.

6 Investments

Summary of proper accounting practices

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

46. 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.

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

Risks of misstatement

48. 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

49. Investments are held to generate income and/or for their investment potential. 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 held to generate income and/or for their investment potential
Current asset	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 made primarily to further the charitable aims of the investing charity (social investments)
Mixed motive	Investments made to generate an investment return and as a social investment

50. **Auditors should** assess whether:

- the charity has identified all investments it holds during 2018/19
- investments have been properly classified.

Investments are not properly measured

51. 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>

52. **Auditors should** confirm that:

- investments in quoted shares, traded bonds and similar investments have been measured at their market value at 31 March 2019
- 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, they should be included at 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 where this can be measured.
- assess whether the valuation of investments at 31 March 2019 is free from misstatement.

Investment income is not properly accounted for

53. 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.

54. 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 fund's assets accrues to that fund unless the terms of the initial gift provide otherwise.

55. 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 market value has been attributed to the endowment capital
- any gain or loss has been allocated correctly to each individual endowment.

56. **Auditors should** confirm that investment income receivable for 2018/19:

- 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

57. **Auditors should** assess whether the charity has identified all the investment properties it held during 2018/19. 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

58. **Auditors should** assess whether:

- investment properties have been measured at their market value at 31 March 2019
- depreciation has been charged on investment property in 2018/19 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

59. SORP paragraph 10.54 requires a charity to disclose:

- the accounting policies for investments, including the basis on which they are valued
- an analysis 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
- an analysis reconciling the opening and closing carrying amounts of each class of fixed asset investment held.

60. 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, and the bases used by them.

61. **Auditors should:**

- confirm that the charity has complied with the charities SORP's disclosure requirements in 2018/19
- assess whether the disclosures are complete, clear, concise and free from misstatement.

7 Donations and legacies

Summary of proper accounting practices

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

63. 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).

Risks of misstatement

64. 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

65. 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).

66. **Auditors should:**

- confirm that donations received during 2018/19 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

67. 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.

Condition	Explanation
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.

68. **Auditors should:**

- confirm that legacies arising during 2018/19 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.

69. Where a payment is received from an estate or is notified as receivable by the executors after 31 March 2019 (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

70. In accordance with SORP paragraph 6.13, facilities and services donated for a charity's own use which it would otherwise have purchased should be recognised as income when received.

71. 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 item that would provide equivalent benefit. 'Value to the charity' may be lower than, but cannot exceed, the price the charity would pay in the open market for the item. An amount equivalent to the amount recognised as income requires to be recognised as an expense under the appropriate heading in the SoFA.

72. 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 2018/19, **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

73. 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.

74. **Auditors should:**

- confirm that the charity has followed the requirements of SORP paragraph 6.31 in 2018/19
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

8 Grant payments

Summary of proper accounting practices

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

Risks of misstatement

76. 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

77. **Auditors should** assess whether all grants made by the charity during 2018/19 have been properly included under the heading of 'expenditure on charitable activities' in the SoFA. 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

78. SORP paragraph 16.13 requires disclosure of the grants paid analysed by: individuals and institutions; and nature or type of activity being supported. Disclosure is not required 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
- 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.

79. Grants to individuals are those made for the direct benefit of the recipient, e.g. to relieve financial hardship or as an educational bursary. All other grants are treated as being to institutions.

80. **Auditors should:**

- confirm that the charity has followed the requirements of SORP paragraph 16.13 in 2018/19
- assess whether the disclosures are complete, clear, concise, and free from misstatement.

Grant commitments are not properly accounted for

81. 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 making the payment. **Auditors should** assess whether a commitment to award a grant in existence at 31 March 2019 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.
82. 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.
83. Where the charity has the discretion to avoid paying grant based on their assessment of whether attached conditions will be met by the recipient. Where a condition remains within the control of the charity, a liability should not be recognised.

Information on funding commitments is not properly presented and disclosed

84. 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.
85. **Auditors should:**
    - confirm that the charity has followed the requirements of SORP paragraph 7.43 in 2018/19
    - assess whether the disclosures are complete, clear, concise, and free from misstatement.

Information on unrecognised grant commitments is not properly disclosed

86. **Auditors should** assess whether the charity has disclosed the existence of any unrecognised grant commitments at 31 March 2019 as a contingent liability including an explanation of how these will be funded.

9 Combinations and winding ups

Summary of proper accounting practices

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

88. A charity merger involves two or more charities combining, usually through the creation of a new charity. Paragraphs 19.27 to 19.33 of FRS 102 and Module 27 of the charities SORP cover merger accounting.

External guidance

89. External guidance referred to in this section is guidance on reorganisation from OSCR.

Summary of auditor's responsibilities

90. 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.

91. However, in practice, 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 2018/19 for a charity wound up during the year, there would be no requirement for an independent auditor's report.

92. **Auditors should**:

- identify if any charities have been removed from the register during 2018/19
- establish whether OSCR require part year 2018/19 accounts.
- where part year accounts are required, audit the 2018/19 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.

Risks of misstatement

93. 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

94. There are generally two options when accounting for the combination of charities, i.e. either merger or as a gift. 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. A significant change in purposes or the beneficiary class would rule out accounting for the combination using merging accounting.

95. The combination should be accounted for as gift when one charity is wound up and its assets and liabilities are transferred at nil consideration into the control of another charity.

96. **Auditors should** assess whether any combination of charities, or the winding up of a charity, during 2018/19 have been accounted for on the correct basis.

Gifts from a wound up charity are not properly accounted for

97. The transfer of assets and liabilities from a charity requires the assets to be measured at fair value by the receiving charity. The required treatment is set out 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 and 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

98. **Auditors should:**

- confirm that a fair value has been estimated by the receiving charity for any assets and liabilities transferred during 2018/19
- 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

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

Issue	Explanation
Aggregation of assets, liabilities and funds	The assets and liabilities of the combining charities are 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 2018/19, the accounts should reflect the results of the combining charities from 1 April 2018.
Comparative information	The accounts should disclose comparative amounts to show the aggregated results for the combining charities for 2017/18, 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.
Accounting policies	Adjustments may be necessary to ensure uniformity of 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 their purposes are identical to the new charity.

100. **Auditors should** assess whether any mergers during 2018/19 have been accounted for in accordance with the above table.

Information on mergers is not properly disclosed

101. **Auditors should:**

- confirm that any new charity created from a merger during 2018/19 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

Summary of proper accounting practices

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

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

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

Risks of misstatement

105. 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

106. 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).

107. **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 group financial statements can be obtained
   - the administering authority's principal purposes and activities
   - how control can be exercised by the authority.

Information on related parties is not properly disclosed

108. 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.

109. **Auditors should** assess whether the charity has disclosed in the 2018/19 statement of accounts the information required by SORP paragraph 9.20.

110. 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.

111. If there have been no related party transactions in 2018/19 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

112. 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.

113. **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

114. 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.

115. **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

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

117. 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

Risks of misstatement

118. 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

119. 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).

120. **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.

121. Financial statements prepared on a receipts and payments basis are not intended to give a true and fair view. Financial reporting standards therefore do not apply to receipts and payments accounts. **Auditors should** confirm that accounts prepared on a receipts and payments basis do not contain any narrative stating that they give a true and fair view.

Statement of receipts and payments is not properly presented

122. 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 2018/19 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.

123. **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.

124. Where a charity has more than one fund in any category, **auditors should** confirm that:

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

125. **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

126. 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 2019:

- distinguishes between unrestricted, restricted, expendable endowment or permanent endowment funds
- reconciles the cash and bank balances at 1 April 2018 and 31 March 2019 with the surplus or deficit shown by the receipts and payments account
- summarises the holding of investments and market valuation
- summarises other assets including gifts 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 2019 (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 trustees.

Information in the notes has not been properly disclosed

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

128. **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.

12 Trustees' annual report

Summary of proper accounting practices

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

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

131. 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 government body's management commentary.

Summary of auditors' responsibilities

132. Auditors' responsibilities for a trustees' annual report are the same as for a local government body's management commentary (explained in section 3 of module 10).

133. The test procedures that auditors should undertake to meet the above responsibilities are summarised in Appendix 2.

134. The model independent auditor's report for 2018/19 will be provided in a separate technical guidance note and will include wording for the trustees' annual report opinions.

Risks of misstatement

135. 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

136. Auditors must consider whether there are any material inconsistencies in 2018/19 between information in the trustees' annual report and the financial statements, and express an opinion in the independent auditor's report.

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.**

137. Auditors should refer to section 3 of module 10 for guidance on the above procedures.

Trustees' annual report is not in accordance with applicable requirements

138. Auditors must consider whether the trustees' annual report for 2018/19 has been prepared in accordance with proper accounting practices, and express an opinion in the independent auditor's report.

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.**

139. 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 Professional Support is that they may be treated as smaller charities.

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

141. 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. In order to assess whether required information has been omitted, auditors should check whether the trustees' annual report includes the items summarised at appendix 3 to this module.

142. If auditors are of the opinion that the trustees' annual report omits a required item, this represents a misstatement. Auditors should request that the charity makes the necessary correction.

Trustees' annual report is inconsistent with auditor's knowledge

143. Auditors must consider whether there are 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.**

144. Auditors should refer to section 3 of module 10 for guidance on the above procedures.

Information in the trustees' annual report is misleading

145. Auditors must consider whether 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.**

146. Auditors should refer to section 3 of module 10 for guidance on the above procedures.

Trustees' annual report is not properly signed

147. 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 statements of account

Council	No of 2017/18 sets of accounts	No of charities in 2017/18	Application of connected charities provisions
North Ayrshire	10	10	Not applied
West Lothian	9	14	Fully applied
Argyll & Bute	8	8	Not applied
Scottish Borders	6	6	Not applied
North Lanarkshire	6	6	Not applied
Aberdeenshire	5	5	No scope to apply
Dundee	3	23	Fully applied
Stirling	3	12	Partially applied
Renfrewshire	3	7	Partially applied
East Ayrshire	3	3	No scope to apply
South Ayrshire	3	3	Not applied
South Lanarkshire	3	3	Not applied
Angus	2	2	No scope to apply
Highland	2	2	Not applied
Fife	1	48	Fully applied
Moray	1	31	Fully applied
Perth & Kinross	1	9	Fully applied
City of Edinburgh	1	7	Fully applied
Aberdeen	1	7	Fully applied
Dumfries & Galloway	1	6	Fully applied
West Dunbartonshire	1	2	Fully applied
East Lothian	1	1	Not applicable
Falkirk	1	1	Not applicable
Shetland	1	1	Not applicable
Orkney	1	1	Not applicable

Appendix 2

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 3

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.	