



AUDIT &  
ASSURANCE  
FACULTY

# GUIDANCE NOTE

October 2010

## GUIDANCE ON SMALL CHARITY AUDIT DOCUMENTATION

Guidance Note

# INTRODUCTION

Practice Note 26 *Guidance on smaller entity audit documentation (Revised)* (PN26 (Revised)), published in December 2009, is designed to provide guidance to auditors on the application of documentation requirements contained within the clarified International Standards on Auditing (ISAs) (UK and Ireland) to the audit of financial statements of smaller entities in an efficient manner. An appendix to PN26 (Revised) includes a number of illustrative examples of audit documentation based on a fictitious for profit company, Bulls Hotel and Restaurant Limited.

This document provides practical examples of audit documentation additional to those included in PN26 (Revised) which are based on a charity. These have been developed by the Audit and Assurance Faculty in order to help members carry out their work. The statutory audit threshold for charities is income exceeding £500,000 (or gross assets exceeding £3.26 million) and many charities with income below this relatively low threshold require an audit, for example as a condition of grant funding.

**This publication is intended to provide practical examples of how auditors might document their work. It does not cover every stage of the audit process and is not intended as technical guidance, although in developing this publication the faculty has checked with members of the Quality Assurance Directorate that the examples represent good practice.**

The examples in this guidance use a single case study, based on a very small charity (around £130,000 incoming resources) and follow the free form documentation illustrations in PN26. They focus on:

- (i) Elements of audit planning, including understanding of the entity, internal control and risk assessment. These represent the areas where most 'new' requirements were added as a result of the introduction of ISAs (UK and Ireland) in 2004 and feedback indicated that further guidance on documentation would be particularly helpful.
- (ii) New documentation requirements introduced in the clarified ISAs (UK and Ireland) for audits of financial statements for periods ending on or after 15 December 2010 relating to materiality.
- (iii) The auditor's conclusions on going concern.

The examples do not cover all charity-specific features that might be encountered by the auditor. The primary source of guidance on an audit approach to a particular transaction, balance, or set of circumstances, is Practice Note 11, *The audit of charities in the United Kingdom (Revised)*, published in December 2008. APB have indicated that an updated 'clarity' version of PN11 will be published for comment later in 2010. The other essential source of reference for auditors of charities is the Charities SORP 2005, *Accounting and Reporting by Charities* (SORP 2005). Cross references to these publications are given in footnotes to the examples where appropriate.

The examples are designed to supplement PN26 (Revised), and are intended to be read in conjunction with that document. Therefore, where the clarified ISAs (UK and Ireland) have introduced new documentation requirements but these do not present special considerations in relation to the audit of a charity (eg evaluation of misstatements and aspects of the planning memorandum for a group audit), auditors can refer to the examples in PN26 (Revised). It is also necessary to refer to the ISAs (UK and Ireland) for the full details of the specific documentation requirements and related guidance, as PN 26 (Revised) is supplementary to the ISAs (UK and Ireland).

The quality and manner of governance of small charities varies very widely. However, the Charity Commission, which regulates charities in England and Wales, has given very clear indications of what it regards as best practice for charities of all sizes in publications such as 'The Hallmarks of an Effective Charity' and 'Internal Financial Controls for Charities'. Grant-making bodies and other major funders expect the charities to which they donate funds to follow best practice in all aspects of their activities. The combination of regulation and donor pressure means that small charities tend to have more formal internal control systems and financial recording procedures than companies of a similar size. In particular, charities that have their accounts audited on a voluntary basis are likely to take governance very seriously and do their best to implement a good internal control system.

The audit procedures including documentation will be the same whether the audit report is made under the Charities Act 2006 or the Companies Act 2006.

We hope that you will find the examples useful but we shall be very pleased to receive any comments or recommendations for additional material to enhance the guidance as a practical, working resource for our members.

## **LIST OF EXAMPLES**

1. Audit strategy memorandum.
2. Notes of understanding the entity.
3. Notes of controls documentation.
4. Risk assessment and response to assessed risks.
5. Free-form notes re going concern.

# EXAMPLE 1 – AUDIT STRATEGY MEMORANDUM<sup>1</sup>

**Client:** Town School and Park Gardens Project  
**Year end:** 31 December 20X1

## AUDIT TEAM

Engagement partner: Paul Cox (PC) [Partner on this audit for eight years]

Audit senior: James Wright (JW) [a newly qualified accountant who has worked on this audit for the last two years.]

## AUDIT REQUIREMENT

The accounts have been audited for many years, because the Local Authority requires audited accounts as a condition of funding. As no election has been made for audit exemption under s477, TSPGP is subject to the audit requirements of the Companies Act 2006.<sup>2</sup>

## CHARACTERISTICS OF THE ENGAGEMENT

- Company limited by guarantee registered in England and Wales, controlled by trustees operating as a management committee (MC) with day-to-day management carried out by a salaried, part-time Director.

### Bookkeeping and accounts:

Accounts are prepared in accordance with Charities SORP and FRSSSE.

Accounting services, including payroll, provided by a self-employed, independent bookkeeper using a standard accounts package.

Audit staff will prepare the statutory accounts from the year-end accounts produced by the bookkeeper.

The permanent file documentation (PAF) provides further information on understanding the charity operations, the control environment and internal controls. This includes notes on understanding the nature of the bookkeeping services provided, how those services affect internal controls, what the implications are for the auditor's procedures to fulfil reporting responsibilities in relation to law or regulation, and what, if any, records are held by the bookkeeper that would be needed by the auditor to provide audit evidence.<sup>3</sup>

## AUDIT PLAN

### Timing

Year end is 31 December.

End November: JW send out bank report request to charity's bankers. Telephone call between JW and Heather Jones [the Director – see notes on ownership and governance in 'Understanding the entity'] (HJ) in early December to confirm what is needed by way of year end documentation and ensure that this is provided by the bookkeeper, respective responsibilities and timing of fieldwork to fit in with trustee meeting for consideration and approval of draft financial statements.

Audit planning and fieldwork by JW during April.

PC to meet with management committee to discuss results and accounts signed on behalf of trustees by end of May.

<sup>1</sup> Documentation requirement at ISA (UK and Ireland) 300 paragraph 12 and ISA (UK and Ireland) 320 paragraph 14.

<sup>2</sup> See APB Bulletin 2009/3, *Auditors' Reports – Supplementary Guidance for Auditors of Charities with accounting periods commencing on or After 6 April 2008* for information about alternative legislation under which the auditor might report.

<sup>3</sup> Requirements of ISA (UK and Ireland) 402 *Audit Considerations Relating to an Entity Using a Service Organisation* set out requirements for Obtaining an Understanding of Services Provided by a Service Organisation Responding to Assessed Risk, Fraud, and Reporting.

## SIGNIFICANT FACTORS

### Materiality<sup>4</sup>

Materiality for the financial statements as a whole has been set at £2,000. This is based on 1.5% of estimated gross incoming resources. As the charity does not have substantial fixed assets, the size of the balance sheet is not taken into account. 1.5% of estimated gross incoming resources is a consistent basis to that used in previous audits.

[Note: materiality has been based on gross incoming resources for this client because it has achieved a steady trend of results, with income derived from charitable activities and grants, and a relatively small balance sheet. Where, by contrast, there is a substantial balance sheet alongside modest incoming resources/ resources expended, eg because the charity has an investment portfolios and/ or property, the more appropriate basis may be the balance sheet total or a combination of balance sheet and incoming resources. Net incoming resources tends not to be useful as a basis for calculating materiality because most charities (especially small ones) rarely have a surplus as they spend all or most of their incoming resources each year. Whatever basis is used, the documentation will need to show and explain how materiality is set.]

### Lower levels of materiality for specific items

The main users of the accounts are the funders (current and prospective) and the Charity Commission. No materiality level has been set for identifying transactions between the charity and individual trustees (and their related parties) because by law all such transactions must be disclosed, except where the trustee has acted as agent for the charity and made purchases on its behalf and has been reimbursed for this expenditure.<sup>5</sup> No separate materiality level has been set for individual restricted funds. However, as the charity must account exactly for restricted funds and may not allow these funds to 'cross-subsidise' each other or unrestricted income funds,<sup>6</sup> any breaches of the conditions relating to any of the restricted funds, irrespective of materiality to the financial statements as a whole, need to be considered in terms of their significance to the audit report and brought to the attention of the trustees.

### Performance materiality

[Note: a number of balances and transactions can be tested by proof in total or other analytical procedures (salaries, rent and rates, grants income and bank accounts). Paragraph A12 of ISA (UK and Ireland) 320 explains that performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected (individually immaterial) misstatements in the financial statements exceeds materiality for the financial statements as a whole. How this figure is calculated is a matter of judgment for the auditor but in general terms a higher percentage (say, 50% or more) indicates that the auditor does not expect to find many errors, or any that are large, whereas a lower percentage might be appropriate where, for example, knowledge of the systems and past audit experience indicate that there could be a number of errors in the accounting records that in aggregate might exceed materiality.]

<sup>4</sup> See also PN11 paragraphs 161 to 166 on the application of ISA (UK and Ireland) 320: Audit Materiality.

<sup>5</sup> Refer to SORP 2005 paragraphs 230 to 233, Trustee Remuneration and Benefits.

<sup>6</sup> Refer to SORP 2005, paragraphs 65 to 76, Accounting for Separate Funds, and Appendix 3, The Funds of a Charity.

### Internal control

The operation of the charity is split between those charged with governance – the trustees – and the day-to-day management by the Director. This means that there is little opportunity for override of controls by the Director and there is no history of override of controls, but we need to remain alert to this risk. The trustees take their responsibilities very seriously.

There are particular internal controls that we can plan to rely on, as documented in the systems information (Ref: PAFxx). In particular:

- Independent bookkeeper maintains accounts and payroll on a standard, well regarded system. The system can produce accounts for any stated period or point in time and the bookkeeper prepares quarterly accounts for consideration at the MC meetings;
- Two signatures required for cheques, (usually the Director and a trustee, sometimes two trustees);
- The charity has electronic banking for which the Director and Treasurer have password access. The only payments that can be made electronically at present are for salaries and PAYE/NI, on the basis of the monthly payment listing provided by the bookkeeper, which must be checked and initialled by the Chair or Vice Chair of trustees or the Treasurer;
- Bookkeeper prepares monthly bank reconciliation (part of accounts package);
- Quarterly-plus MC meetings at which actual income and expenditure is reviewed against budget as a standing item on the agenda.

### Results of previous audit

No matters were identified during the previous audit to suggest a significant change in audit approach is needed.

### Developments in the business

JW went to the charity's office on 15/04/X2. The purpose of the visit was to discuss with HJ (the Director) how the charity had got on in the financial year and since then and to find out whether there had been any developments in its operations since the last audit that may impact the audit of the current period. The discussion also covered the risk of material misstatement of the financial statements due to fraud, asking HJ what measures are taken by the trustees working with her and through supervision/management committee meetings, to identify and address fraud risk. Also asked whether HJ was aware of any actual or alleged fraud affecting the charity.

HJ said that there had been no significant changes in the charity's activities or applicable laws and regulations since the last audit and no changes in the charity's staff. However, the current poor economic climate has made it harder to secure new funding as there is increasing competition between charities and major funders themselves see diminishing returns from investments. The LEA grant is also far from guaranteed in the face of the recent change in overall control of the Council and threatened cuts in public spending.

However, HJ considers that the charity occupies a niche and is well-regarded, and she is confident that at least two of the funding proposals she has made to major grant providers will be successful, so that the charity's ability to continue as a going concern is not threatened.

JW asked HJ whether she was aware of any breaches of applicable law and regulations (including breaches of any terms of restricted funding) that had occurred in the year or since the year end and HJ said she was not (note for partner attention to ask same question of trustees when discussing draft accounts at MC meeting in May).<sup>7</sup>

Heather added that she considers the risk of material misstatement of the financial statements due to fraud to be very low because there is very little opportunity or incentive for fraud. Normal anti theft measures are taken to safeguard against loss due to theft of assets (eg, physical security and insurance of eg, computer

<sup>7</sup> Documentation requirement ISA (UK and Ireland) 250 Section A paragraph 29.

and gardening equipment); gardening materials relatively bulky, low value and not held in large quantities; few staff, on fixed salaries with any overtime requiring justification and authorisation by director, separation of bookkeeping and authorisation of transactions; trustee regular review of management accounts. More detailed notes on the operations of the charity are in the Permanent audit file (PAFxx) and on the trustees' assessment of fraud risk and measures to identify and address the risks at PAFxx.

### **Risk assessment procedures performed**

A preliminary analytical review of the [bookkeeping package] year end accounts was carried out (ref Bxx). The results for the year to December 20X1 are similar to those for the previous year. No unusual relationships were identified in fees charged for school gardening projects and costs of materials and seasonal staff. The significant risks are:

- Funds accounting – that income or expenditure may be allocated to wrong fund or funds spent in a way that contravenes grant conditions, resulting in bad publicity, difficulty in obtaining new funding, or even withdrawal of funds;
- Incomplete income recording if fees to schools for projects are missed;
- Incorrect/inappropriate calculation of deferred income;
- Non receipt of income from funder because charity has to apply for funds to be released or provide progress report, and fails to do this.

Further details on these risks and other matters giving rise to significant risks and how they will be addressed are documented in the risk assessment and response to assessed risks in the Current audit file at (CAFxx).

### **PROVISION OF NON-AUDIT SERVICES**

We prepare the statutory accounts from the [bookkeeping package] accounts, although accruals, prepayments and depreciation calculations are done by the bookkeeper. There are thus self-review and management threats. We comply with APB Ethical Standards through reliance on PASE because the client has 'informed management' (although not having formal accountancy training, the office holders have a good grasp of the principles involved in running and accounting for the charity, James Woodruffe runs his own business, and Mary Gardner prepares the accounts for her local church). The implications of the provision of non audit services must be discussed by PC with the trustees when they meet to consider the accounts (audit working papers to include documentation of this discussion). Any adjusting journals suggested by us in the course of the audit must also be listed and discussed with the trustees at the meeting and the list signed by them as evidence of their understanding and approval of the adjustments. The self-review threat is addressed by completion of a specialist accounts disclosure checklist published by [name of training organisation or publisher].

[Note: The firm's audit manual or policies and procedures would normally contain details of: the firm's approach to the provision of non-audit services; the consideration of threats resulting from non-audit services provided and measures to safeguard against these; and communication of the issues and considerations to those charged with governance (the trustees in the case of a charity). APB PASE states that, in the case of an audit of a small entity, alternative procedures to address the self-review threat involve discussions with 'informed management', supplemented by an extension of the firm's cyclical inspection of completed engagements that is performed for quality control purposes.

The provision of accounting services also gives rise to a management threat and this is dealt with in APB ES5. The charity's trustees are responsible for the preparation of the financial statements and maintenance of the accounting records so, for example, any adjusting journals proposed to correct items highlighted by audit procedures must be explicitly approved by the trustees.]

Because of this, we do not consider that disclosure is required in either the audit report or the notes to the accounts.

## Nature, timing and extent of resources allocated

Activity	Details	Est. hours	Due by
Planning	Send bank letter request (JW)		30/11/X1
	Ring HJ to discuss y/e procedures, who does what in preparing for audit (HJ vs. JW) and timing of fieldwork. Email HJ to confirm.	JW x hours	10/12/X1
Fieldwork	JW attend at TSPGP premises: review permanent file information, walk-through systems to confirm, update PAF as necessary, draft audit strategy, prepare audit programs	JW x hours	15/04/X2
	PC and JW discuss audit strategy; PC review and sign off on PAF, strategy and programmes. JW record discussion	JW and PC x hours each	22/04/X2
	JW attend at TSPGP premises to carry out planned work	JW x hours	29/04/X2
	JW draft financial statements, complete accounts disclosure checklist, check audit documentation/tidy file and prepare notes for partner attention	JW x hours	06/05/X2
Partner review	PC – includes discussion with JW		
	Draft representation letter and management letter	PC & JW x hours each	13/05 /X2
MC meeting	PC attends to discuss audit and answer any queries prior to MC approval of accounts	PC x hours	20/05/X2
	Sign audit report (provisional)		
Signed by:	James Wright	Date:	15/04/X2
Signed by:	Paul Cox	Date:	22/04/X2
No revisions to these items were found to be necessary during the course of the audit.			
Signed by:	James Wright	Date:	13/05/X2
Signed by:	Paul Cox	Date:	13/05/X2



## EXAMPLE 2 – NOTES OF UNDERSTANDING THE ENTITY<sup>8</sup>

**Client:** Town School and Park Gardens Project

**Year end:** 31 December 20X1

### **Nature of the entity**

Company limited by guarantee registered in England and Wales, established about 10 years ago and registered as a charity from the outset. There are six trustees who meet every quarter with additional meetings if necessary. (Management Committee – MC). Day to day management is the responsibility of a salaried, part time (3/4 FTE) Director, who acts as Company Secretary and attends the management committee meetings.

There are two part time salaried gardeners (hours and therefore pay vary according to season) and a small pool of seasonal staff, paid on the basis of hours worked.

Activities include:

- Public garden maintenance with volunteers.
- Wildlife gardening and medicinal herbs.
- Family play schemes.
- Gardening clubs in early years centres, primary and secondary schools.
- Corporate volunteer days.

### **Sector, regulatory and other relevant factors**

The charity sector is subject to substantial regulation under Charities legislation.<sup>9</sup> We have a duty to report matters to the Charity Commission that come to our attention in the course of our audit that we consider are relevant to the CC's for the exercise of its functions. Central to this is TSPGP's compliance with its own stated objectives and constitution.<sup>10</sup>

The charity's objects are listed at (PAFxx). In summary the charity aims to promote the benefit of the inhabitants of the town through providing facilities and promoting the conservation, protection and improvement of the physical and natural environment in the area.

Funds must be accounted for precisely to ensure monies are spent in accordance with any conditions imposed by donors. It is vital to ensure that there is no netting off between funds. Grant-making organisations are increasingly strict in monitoring the performance of grant recipients.

With the implementation of the Charities Act 2006, increasing attention is being paid to the 'public benefit' test. As TSPGP is a charity registered in England and Wales, the trustees must include in the Trustees Report information about the activities undertaken to further TSPGP's objectives for the public benefit and a statement that the trustees have had regard to the Charity Commission guidance on public benefit.<sup>11</sup>

Because the charity's work involves contact with children, all staff and any trustee who is involved in the activities must undergo a CRB check (soon to be vetting and barring scheme (VBS)).

There is some seasonal fluctuation in the charity's activities, in that winter months tend to be quieter, but school holidays can be as busy as term times, with eg, field trips being organised during the spring and summer holidays.

<sup>8</sup> Documentation requirement at ISA (UK and Ireland) 315, paragraph 32(b).

<sup>9</sup> Charities may also be subject to sector-specific regulation if they operate in sectors such as education, health/welfare or social housing, and all are subject to trust law – see Charity Commission publication CC3, *The Essential Trustee – What you need to know and Being a Trustee*.

<sup>10</sup> See PN11 section on ISA (UK and Ireland) 250 for detailed consideration of compliance with laws and regulations.

<sup>11</sup> See Charity Commission publication *Charities and the Public Benefit*.

Because it invoices schools for activities it arranges or provides, the charity has to be aware of rules regarding charity trading and VAT. In this case, the sales are regarded as made in the course of primary purpose trading. The value of sales is currently well below the registration threshold for VAT but thresholds need to be borne in mind.

The charity also has to be careful in relation to the correct operation of PAYE. Need to ensure in relation to seasonal staff that they have the necessary proof and undertakings before eg, paying students or freelancers without deduction of tax.

### **Ownership and governance**

TSPGP is controlled by the trustees, who are also charged with governance. There are currently six trustees:

Geraldine Rose (chair) – retired head teacher  
James Woodruffe (vice chair) – self-employed  
Mary Gardner (treasurer) – retired social worker  
Frank Flowerdew – retired local government officer  
Harriet Kirschenbaum – part time carer  
Veronica Bloom – teacher  
Director: Heather Jones (has been in post for about five years)

The trustees plan and direct the operation of the charity through management committee meetings at which they monitor progress by reviewing and discussing management accounts and progress report prepared by Director. Review of minutes in previous years has shown the attendance record of all current trustees to be good.

### **Related parties**

Related party transactions are an issue because of strict rules and disclosure requirements. James Woodruffe is a partner in a local garden centre business and can therefore arrange to supply many of the materials used by the charity at cost price. In addition, Heather Jones (HJ), the Director, is a trustee of City Green, a community garden project to which TSPGP supplies gardening and related services.

### **Organisational structure and financing:**

The salaried Director is responsible for day-to-day management and fundraising. In addition to the oversight of management through committee meetings, one of the trustees (usually the treasurer or the chair) goes to the charity's office in the middle of each month to sign cheques and review the bank reconciliation, and discuss progress with the Director.

Bookkeeping and payroll are carried out by an independent bookkeeper, using a standard computerised package, from which management accounts are prepared for MC meetings. Statutory accounts are prepared in accordance with the Charities SORP and FRSE – there are no unusual accounting policies to consider.

Income is derived from: grants from the local authority; grants/donations from grant-making charities; and invoices for work undertaken for local parks & gardens and schools. Apart from money held on bank deposit account, the charity does not have income generating investments. Management accounts for the current year show:

- Annual grant of £40,000 from the education department of the local authority (confirmed for a 3-year period starting in 20X1).
- Three major, national funders and two small local trusts providing between them £50,000 for specified projects of which £30,000 is due to end in the coming year.
- Fees charged to schools for setting up and running gardening clubs, etc – £35,000 in the previous year.
- Small amount of donations (by cheque or bank transfer only, not cash).

Total incoming resources therefore about £120,000–£130,000.

The balance sheet total is about £60,000.

The charity operates two CAF accounts, current and deposit, with an average aggregate balance of about £40,000, though levels vary according to timing of receipts from funders. There is a small balance of fees due from schools at any one time, normally not more than £5,000. Year-end creditors are typically between £8,000–£12,000, and there may in addition be an amount of deferred income, depending on the timing of receipts from funders and relevant expenditure.

About 60% of outgoing resources are represented by staff salaries and a further 5% on seasonal worker costs. Materials/gardening supplies are approximately 15% of costs and rent and office service costs 10%. The [computer package] accounts prepared by the bookkeeper show a surplus of income over expenditure of about £5,000.

The charity occupies, rent-free<sup>12</sup>, office space in a building that is itself owned and run by a local social enterprise. There is a small van, acquired second hand for £8,000 in 20W8. Office furniture and equipment comprises relatively cheap office furniture (mostly second-hand) and computer equipment.

The trustees have decided that their reserves policy should be to build up then maintain unrestricted funds to about £40,000, or between three and six months' operating costs. This is partly to cover the cost of emergency staffing – see controls notes on PAF4xx. The balance on unrestricted funds at 31 December 20X0 was £30,000; and the trustees have designated £8,000 of this to replace the van in the next two–three years. Restricted income funds at 31 December 20X0 were £30,000.<sup>13</sup>

The figures show the financial position and continuation of funding to be relatively secure: a further going concern review will be undertaken before the accounts are signed off.

Originally prepared by A N Other Date November 20W8

Sources of information referred to or checked:

Discussion with Heather Jones (15/04/X2);

Companies House – current appointments report and Annual Return made up to February 20X2;

Charity Commission register – details of trustees including other charity trusteeships;

Review of financial statements;

Management accounts; and

Review of PAF and previous year's CAF.

Updated for 20X1 audit by James Wright

Date 15/04/20X2

<sup>12</sup> See SORP paragraphs 133 to 136 for donated services and facilities. Auditor needs to consider how donation in kind has been valued by the charity for disclosure in the SOFA.

<sup>13</sup> See SORP 2005 Appendix 3, The Funds of a Charity, which explains the legal position as regards the different sorts of funds that a charity may have.

## **IMPACT ON THE AUDIT – RISKS OF MATERIAL MISSTATEMENT RELEVANT TO AUDIT FOR THE YEAR ENDED 31 DECEMBER 20X1**

### **At the Financial Statement Level**

1. No pervasive risks of material misstatement have been identified. The assessment of risk at the financial statement level is 'low'.

### **At the Assertion Level**

2. Cut-off in relation to grants and expenditure for which grant given needs to be checked in relation to stated policy for revenue deferral as deferral of income will have a material impact on net incoming resources.<sup>14</sup>
3. Fraud. Eg, inflation of payroll (overtime claimed, not worked); 'fiddling' of expenses; fictitious suppliers or invoices.
4. Failure to report and quantify related party transactions.
5. Incomplete income due to failure to invoice for services provided or to record invoices issued.
6. Bad debts.
7. Non receipt of income due from funder.
8. Misapplication of restricted fund. Accurate allocation of expenditure across funds in accordance with purpose and conditions of grant is essential. As noted in audit strategy memorandum, any breaches of the conditions relating to any of the restricted funds, irrespective of materiality to the financial statements as a whole, need to be considered in terms of their significance to the audit report and brought to the attention of the trustees.
9. Going concern: the charity does not have substantial fixed assets or long-term liabilities that would have to be revalued or reclassified if the going concern basis became inappropriate, but as the charity is reliant for most of its income on voluntary donations, which can take a lead time of many months from initial application to receipt of funds (and unsuccessful attempts) the trustees have to maintain rolling projections of at least 2 years to plan their fundraising activities to maintain their cashflow.

The planned audit response to assessed risks is detailed at CAFxx [see Example 4].

<sup>14</sup> See SORP 2005 paragraphs 94 to 111, *Recognition of Incoming Resources* and Glossary GL 15, *Deferred Income*. SORP 2005 paragraph 318 shows that deferred income is included in the accounts with accruals.

## EXAMPLE 3 – NOTES OF CONTROLS DOCUMENTATION<sup>15 16</sup>

**Client:** Town School and Park Gardens Project

**Year end:** 31 December 20X1

### **Control environment**

Trustees' meetings are held quarterly, where management accounts are reviewed, current operations discussed, and fundraising and future plans considered. Heather Jones attends as the charity's Director and company secretary and one representative each of the LEA and Parks Department attend by invitation.

The trustees take their position very seriously and attendance is good: meetings are arranged well in advance to ensure that all trustees are able to attend and it is made clear that they are expected to do so. Although HJ prepares the documentation for the meetings and takes minutes, the trustees do not simply rubber stamp decisions.

The trustees approve a budget in advance of each year and budgeted figures are compared to actual in the management accounts: the monthly management accounts are prepared by an independent bookkeeper. The bookkeeper was recommended to TSPGP by another local charity. She is a member of the Institute of Certified Bookkeepers and attends at the charity's office for about 4 hours every week to enter transactions on the [bookkeeping package] system and (once a month) do the bank reconciliation and run the payroll using [bookkeeping package] routines. Salaries are paid electronically by the Director but the payment schedule, accompanied by the payroll printout showing the make up of each employee's pay and deductions must be approved by a trustee before the transfers to individuals' accounts are effected.

### **Risk assessment process**

Following recommendation by the auditors, the trustees have instituted a simple risk register and it is a standing item on each agenda for the risk assessment to be reviewed and updated if necessary. The key risks identified are:

1. Funding – that the charity will be unable to secure funding to continue its operations for the long term;
2. Funding – that the charity will not receive all the income to which it is entitled;
3. Funding/reputation – that the charity will breach conditions attached to restricted fund;
4. Reputational – loss of funder and public support if unable to demonstrate usefulness and unique features;
5. Liability – risk if children or public are injured etc. as a result of charity activities or negligence or staff action;
6. Staff/key person – risk of loss of continuity or ability to operate if Heather Jones falls ill, leaves, or retires;
7. Staff or volunteer shortage – so either incurs additional cost of having to take on extra employees or loses funding because of the inability to fulfil obligations.

Controls established to address these risks are:

1. Prepare cashflow projections to cover term of known funding and planned expenditure and identify as early as possible the points at which expenditure exceeds income, in order to apply for new grants as early as possible;
2. Prepare an income calendar of when grants etc are due and ensure that reports are submitted if and when required to prompt further instalment, and to chase any funder that has not paid promised instalment when due; Director obtain debtors listing from bookkeeper each month and follow up all balances due over more than one month;

<sup>15</sup> Documentation requirement at ISA (UK and Ireland) 315 paragraph 32(b).

<sup>16</sup> See also ISA(UK and Ireland) 402 requiring understanding of use made of service organisations especially for maintenance of accounting records.

3. Maintain separate accounts for all funders using 'department' codes in bookkeeping package;
4. Management Committee review Director activity report against charity objectives and major funders' agreements to ensure TSPGP is meeting its stated objectives. To have a 'brainstorming' session at each meeting to consider whether there are other projects that could be undertaken to extend activities and maximise potential;
5. Ensure strict procedures for all new salaried staff and seasonal workers, obtaining and following up references (minimum two) plus CRB check. Carry out three and six months probationary reviews before confirming salaried staff appointments;
6. General: review actual against budgeted expenditure every quarter and follow up unexplained variances. Two signatures required on all cheques, being two trustees or one trustee and the Director. There is no petty cash float in the office, but the staff have a £100 float each, for which they are accountable, from which they meet necessary small items of expenditure. The float will only be topped up on completion of a petty cash form, supported by receipts, etc. and signed by the Director (the Director claim form is effectively authorised by a trustee as part of the cheque signing process);
7. Build up unrestricted fund to enable charity to hire emergency/interim staff;
8. Consider and agree contingency measures;
9. Ensure there is a comprehensive, up to date office systems manual so that an interim manager could understand and pick up the threads without too much difficulty.

See PAF 3xx for notes on design and implementation of the information systems, controls relevant to the financial statements, payment controls, payroll operation, etc. and the monitoring of controls. Also notes on the evaluation and effectiveness of controls.

**Originally prepared by A N Other Date November 20W8**

**Continued operation of the implementation of the above controls and PAF3xx confirmed by walkthrough and observation as noted on Bxx. Internal control notes updated for 20X1 audit by James Wright Date 15 April 20X2.**

## EXAMPLE 4 – RISK ASSESSMENT AND RESPONSE TO ASSESSED RISKS<sup>17</sup>

**Client:** Town School and Park Gardens Project  
**Year end:** 31 December 20X1

Note: The table in this example is based on that in PN 26 Example 8. It contains examples of assessed risks of material misstatement and the auditor's response to those risks. The risks and procedures are not exhaustive and will not necessarily be relevant to other charities in other circumstances. The purpose of the table is to show how the auditor might document:

- consideration of the risks of material misstatement in the accounts of this charity;
- controls established by trustees to prevent misstatement;
- gaps in controls (which should be included in formal report to those charged with governance, if the risk is significant and the impact would matter to the charity);
- audit procedures in light of risk and internal controls assessment.

The risks of material misstatement in the financial statements will not necessarily be the same as the risks identified by the trustees, although there is likely to be some overlap.

The following list represents all the risks identified by audit staff and considered to require an audit response in the case of TSPGP, accompanied in some cases by consideration of mitigating internal controls. This is just to illustrate a possible thought process. In practice, auditors would not duplicate the list of risks and responses: as in PN 26 Example 8, the risks, assessment, mitigating internal controls and audit procedures would be combined on a single schedule.

Risks identified and assessed:

### At the Financial Statement Level

1. No pervasive risks of material misstatement have been identified. The assessment of risk at the financial statement level is 'low'.

### At the Assertion Level

2. Cut-off in relation to grants and expenditure for which grant given needs to be checked in relation to stated policy for revenue deferral as deferral of income will have a material impact on net incoming resources.<sup>18</sup>
3. Fraud. Eg, inflation of payroll (overtime claimed, not worked); 'fiddling' of expenses; fictitious suppliers or invoices.
4. Failure to report and quantify related party transactions.
5. Incomplete income due to failure to invoice for services provided or to record invoices issued.
6. Incomplete income due to failure to receive agreed instalment of grant.
7. Bad debts.
8. Non receipt of income due from funder.
9. Misapplication of restricted fund. Accurate allocation of expenditure across funds in accordance with purpose and conditions of grant is essential to avoid breach of grant conditions.
10. Going concern: the charity does not have substantial fixed assets or long-term liabilities that would have to be revalued or reclassified if the going concern basis became inappropriate, but as the charity is reliant for most of its income on voluntary donations, which can take a lead time of many months from initial application to receipt of funds (and unsuccessful attempts) the trustees have to maintain rolling projections of at least two years to plan their fundraising activities to maintain their cashflow.

<sup>17</sup> Documentation requirements at ISA (UK and Ireland) 240, paragraph 44(b) and 45(a), 315, paragraph 32(c) and (d), ISA (UK and Ireland) ISA (UK and Ireland) 330, paragraph 28(a) and (b).

<sup>18</sup> See SORP 2005 paragraphs 94 to 111, *Recognition of Incoming Resources* and Glossary GL 15, *Deferred Income*. SORP 2005 paragraph 318 shows that deferred income is included in the accounts with accruals.

## AUDIT RESPONSE TO ASSESSED RISKS

1. No pervasive risks at financial statement level  
No risk identified therefore no response needed.

2. Cut-off and deferred income.

Controls: [bookkeeping system] enables income and expenditure actual and budget to be tracked for each donor/restricted fund and Director checks that restricted funds are expended in accordance with specified terms and amounts received for specified expenditure not incurred until the next accounting period are deferred.



### 3. Fraud

There doesn't appear to be unusual incentive or pressure on trustees or staff to commit fraud; the salaried and seasonal staff are paid on local authority payscales and the number of applicants from well qualified people for the last gardener post that was advertised indicates that salary levels are acceptable. From previous experience, the atmosphere at the charity feels very good; staff are clearly motivated and very confident that what they are doing is worthwhile. The charity has a very good reputation locally and the audit relationship has always been open and friendly.

Controls in place to prevent or detect the override of controls by the Director are: trustee review of management accounts including checking actual results against budget; cheque signing/electronic banking procedures, payroll operation by independent bookkeeper coupled with trustee approval of monthly payroll payment schedule. See detailed systems notes (PAFxx).

Operation of controls to be verified by walk through tests and through review of minutes of MC meetings and risk of misstatement due to fraud assessed as low. No special fraud procedures considered necessary but watch out for indicators such as large budget variances that could indicate unauthorised expenditure.

JW to ask Heather whether she has been aware of any fraud or allegations of fraud affecting the charity in the year.

PC to discuss with Trustees at the accounts review meeting their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud; ask whether they have assessed the risk that the financial statements may be materially misstated as a result of fraud and, if so, what was the assessment; ask whether they are aware of or suspect that there has been any fraud, or any allegations of fraud, affecting the charity.

Obtain written representations from trustees.<sup>19</sup>

### 4. Failure to report and quantify related party transactions

Etc.

<sup>19</sup> ISA (UK and Ireland) 240 paragraph 39.

Risk of material misstatement identified	Significant risk?	Mitigating internal controls	Likelihood of risk resulting in material misstatement
(1)	(2)	(3)	(4)
2. Cut-off and deferred income	Yes	Bookkeeping system allows actual receipts/expenditure to be checked against budget at individual donor level	High
3. Fraud	Yes	<p>Bookkeeping is done by an independent bookkeeper</p> <p>Quarterly accounts are checked at MC meetings against budget</p> <p>2 cheque signatories for every cheque. Electronic payment of salaries operated by Director but requires trustee approval of payment schedule</p> <p>Payroll maintained by independent bookkeeper</p> <p>Overtime must be authorised by Director</p> <p>Staff are accountable for their own petty cash floats, which are only topped up upon submission of itemised claim forms supported by receipts</p>	Low
4. Failure to report and quantify related party transactions	Yes	Trustees have set up a 'register of interests' listing their and the Director's other directorships and business interests	High
5. Incomplete income due to failure to invoice for services etc		Director maintains a diary of school gardening project work undertaken and prepares invoices from this each month	Med
6. Incomplete income due to failure to receive agreed instalment of grant		Director maintains a grant calendar on which she records all grants etc showing date due to be paid and any conditions to fulfil before grant release eg, progress report	Low (because any material shortfall in income would be picked up)
7. Bad debts		Bookkeeper maintains sales ledger which generates aged listing of debtors and she chases invoices overdue for payment	Low
8. Non receipt of income due from funder		Director maintains a grant calendar on which she records all grants etc. showing date due to be paid and any conditions to fulfil before grant release eg, progress report	Low (because any material shortfall in income would be picked up)
9. Misapplication of restricted fund	Yes	<p>12 month budget prepared in advance of year showing income and expenditure by fund, by month</p> <p>Management accounts record income to and expenditure from individual funders as distinct departments</p> <p>Management accounts provide detailed income &amp; expenditure for each funder</p> <p>Monthly management accounts enable Director to check allocations and follow up variances from budget: quarterly accounts checked against budget by management committee</p>	High
10. Going concern	Yes	<p>Monitoring and control of cash flow by Director and trustees</p> <p>Planning fundraising to meet long term needs and spending requirements of projected activities</p>	High

Assertions impacted	Audit procedures C = test of control S = substantive procedure	Sch ref
(5)	(6)	(7)
Cut-off Completeness Valuation Rights & obligations	C: Check for income & exp. actual v budget at restricted donor level  S: Check grant documentation, to see that amount deferred relates to grant for expenditure cannot be incurred until the next accounting period.	
All	C: review minutes of MC meetings to see that accounts are prepared by independent bookkeeper and are compared to budget  C: check bank mandate  C: check payroll printouts (walkthrough) C: check overtime paid to hours authorised by HJ C: check operation of petty cash float system (walkthrough) C: PC discussion with MC at meeting held to review accounts for approval S: sample all expenditure not covered by proof in total or other test, to supporting documentation	
Presentation & disclosure: completeness & classification	C: inspect register of interests  S: Note names of parties to watch out for when checking documentation on outgoing resources	
Completeness	C: look at diary  S: check a sample of projects from diary to recorded sales  S: compare costs of gardening projects as a percentage of invoiced income to that for previous year	
Completeness	C: look at grant calendar  S: check total grant receivable per calendar to total received per accounts	
Existence Valuation	S: check year end aged debtor listing to payments received after year end	
Completeness	C: look at grant calendar  S: check total grant receivable per calendar to total received per accounts	
Accuracy	C: check existence of budget  C: check existence of monthly management accounts  C: check minutes of management committee meetings for evidence that trustees have considered quarterly accounts, compared actual income and expenditure to budget, and responded to any significant variances  S: check recorded income to correspondence with funder for amount, timing, and conditions	
Presentation and disclosure	C: Review of MC minutes  C: Review of cash flow projections  C: Discussion by JW with Director and PC with trustees of future plans and assessment of funding/going concern risk	

## EXAMPLE 5 – NOTES RE GOING CONCERN<sup>20</sup>

**Client:** Town School and Park Gardens Project  
**Year end:** 31 December 20X1

### **Planning:**

TSPGP was established about 10 years ago in a large metropolitan area and has grown slowly but steadily to date. It is well regarded locally and fills an important niche. It has secured funding from the local education authority and from some major national funding bodies and has built up about £30,000 in unrestricted funds (about three months' expenditure).

From previous year's audit file and discussion with Heather Jones, the funding position is:

- LEA grant is subject to annual review (based on audited accounts) but informal indications have been given that funding is secure for at least two years to the end of March 20X4, when the next local elections are due;
- Two major grants covering three years are due to come to an end in the current year (Jan-Dec 20X2);
- The current year's surplus of income over expenditure, before any adjustments for deferred income, is about £5,000;
- Heather Jones is currently working on funding bids to Universal Benevolent Fund and Local Amenity Trust
- The charity was unsuccessful in a bid for funds from the XYZ Trust in the summer.

The trustees were told by the XYZ Trust that the reason the application was unsuccessful was that available funds were reduced due to economic conditions and that there were other applicants for the current round of funding whose profiles matched XYZ's stated objectives more closely. XYZ did not rule out the possibility of considering a new application from TSPGP in the future. This suggests that the charity is well regarded, and should be able to secure grants from funders for whom it has a better fit. HJ has received positive feedback from both Universal Benevolent Fund and Local Amenity Trust and expects to hear from the former in the next two-three weeks. On the basis of the current financial position and cashflow projection for 18 months from January 20X2, the going concern basis appears to be appropriate, but if TSPGP is unsuccessful in its applications for new funding, it may be necessary to include an explanatory note in the accounting policies and an emphasis of matter paragraph in the audit report.

**Prepared by James Wright**      **Date: 10/12/X1**

### **After field work:**

The surplus for the year after deferred income adjustments was £3,000. The application to Universal Benevolent Fund was successful, though it was scaled back to three-quarters of the amount requested. TSPGP has still not received a decision from Local Amenity Trust but feedback continues to be promising. The MC/Director have updated the cashflow projections to take account of both actual receipts since the year end and to include the new funds that will come on stream from UBF in the autumn. As part of our post balance sheet review we compared the updated projections and budget to actual income and expenditure in the [bookkeeping package] accounts up to 30 April X2. The comparison showed the projections and budget to be close to actual income and expenditure and the projected cash position appear to be adequate to cover the activities of the charity.

<sup>20</sup> Documentation requirement at ISA (UK and Ireland) 230 paragraph 8(c) – significant matters arising during the audit.

**Conclusion:**

Although the current economic conditions are particularly difficult for charities there are no indications that TSPGP will not continue in operational existence for at least one year from the date of approval of the accounts: on the contrary, the funding position appears to be sound for at least two years from the date of approval of the accounts. The accounting policies include a short explanatory note about the adoption of the going concern basis and I consider that this is clear and understandable, although it will not be possible for the charity to commit to any significant expansion (it would like to construct a small 'eco' centre in one of the local parks, to serve as a study centre as well as providing storage facilities and a base for gardening staff, and this centre will be the subject of a specific approach to relevant trusts and funding bodies).<sup>21</sup> I do not consider that added emphasis in the audit report is necessary.

**Prepared by James Wright****Date: 06/05/X2****Reviewed by Paul Cox****Date: 13/05/X2**

<sup>21</sup> Financial Reporting Council: *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* (October 2009) includes examples of going concern disclosures for small companies that have adopted the FRSSE in preparing their accounts. The guidance in the FRC publication is relevant to all entities preparing true and fair accounts, not just companies. It is particularly relevant for all charities given projected government cuts and the difficult economic conditions.