CHARITY COMMISSION FOR ENGLAND AND WALES

OSCR Scottish Charity Regulator

The Charity Commission for Northern Ireland

An Rialálaí Carthanas Charities Regulator

Audit Reform and Regulation Team
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CIPFA
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11 June 2019

Dear Sirs,

**Independent Review of the Financial Reporting Council – *Initial consultation on the recommendations***

On behalf of the Charities SORP-making body for the UK and Ireland, we are responding to the initial consultation on the recommendations made by the Independent Review of the Financial Reporting Council. The Charity Commission for England and Wales, the Charity Commission for Northern Ireland, and the Office of the Scottish Charity Regulator are established by law as the regulators and registrars of charities in the UK and currently comprise the charities SORP-making body. We are assisted by the Charities Regulator, the regulator and registrar of charities in the Republic of Ireland.

The Charities SORP is an interpretation of UK-Irish Generally Accepted Accounting Practice for charities. It is developed and maintained in accordance with the FRC's Policy on Developing SORPs. The Charities SORP-making body is responsible for developing and maintaining the Charities SORP, and in doing so is accountable to the FRC. Our organisations work closely with the FRC's Accounting and Reporting Policy team in carrying out this responsibility.

We welcome the Independent Review's recommendations and the opportunity to comment on how these are taken forward. Our comments to those questions posed by the consultation are out in an annex to this letter. As our expertise is confined to charities accounting and reporting, we have answered those relevant to our remit. Given that charities represent the larger part of the UK's public benefit entity sector, our comments aim to reflect the wider perspective of this sector.

We note that within the charity sector, financial reporting plays an important role in enhancing accountability and supporting the building of public trust and confidence. Instances of poor reporting practice, however isolated, have the potential to inflict considerable damage, which include undermining

the sector's ability to access funding. However, the review's recommendations fail to recognise the new regulator's remit in setting accounting and auditing standards for charities in several key areas. Whilst we acknowledge the factors that prompted the review arose primarily from the private sector, it is important that the opportunity is not lost to improve the regulatory framework for the full range of entities for which the new regulator is responsible. Therefore, we recommend greater consideration is given to the broad range of entities that will apply the standards set by the new regulator. This should be reflected in the regulator's overall objective, and evidenced in the composition of its board and structure of its panels and committee.

We support the recommendation for the new regulator to act collaboratively and work closely with other UK regulators. As the regulators of the charity sector in the UK, we look forward to working with the regulator in this capacity.

In the event of any enquiry concerning our response, please contact CIPFA as secretariat to the joint Charities SORP-making body, at the above address.

Yours sincerely,

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Nigel Davies
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Professional Accountant
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**Annex: Charities SORP-making body response to the consultation on the recommendations made by the Independent Review of the Financial Reporting Council**

**Q1. What comments do you have on the proposed objective set out in Recommendation 4?**

We support the new regulator having a clear and comprehensive strategic objective. However, the proposed strategic objective does not take into account the reporting and auditing standards that the new regulator will set are applicable to other entities in addition to companies.

For example, many charities that are not incorporated in the UK prepare their financial statements in accordance with UK accounting standards (where they are also required to comply with the Charities SORP). Similarly, the audit of their financial statements is conducted in accordance with UK auditing standards (ISAs (UK)).

We would like to see the wide impact of the new regulator’s core functions in audit and reporting of all relevant entities reflected in its objective. We would suggest that those references that confine the regulator’s scope to companies are amended as follows:

> “To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, ~~corporate~~financial reporting and corporate governance, and by holding to account the entities~~companies~~ and professional advisers responsible for meeting those standards.”

**Q2. What comments do you have on the duties and functions set out in Recommendations 5 & 6?**

We support the proposal for the new regulator to be collaborative and work closely with other regulators. We believe that there is scope for the regulator to work more closely with the members of the Charities SORP-making body, as the regulators of the charity sector in the UK. Collaboration would help to identify cases of wrongdoing in reporting and accounting or poor practice, in order for effective action to be taken by the regulators and professional bodies.

Currently each of the UK charity regulators work with other bodies that have regulatory responsibilities. These existing arrangements are set out in contracts and Memoranda of Understanding which provide details of joint-working and the sharing of information. We believe there is scope for similar agreements to be established with the new regulator to provide a framework for collaboration. We look forward to working with the new regulator to identify such opportunities.

Comments on the other functions of the new regulator are included within our response to Question 5 and Question 7 on the effectiveness of the FRC's core functions.

**Q4. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?**

Comments on those considerations which should be borne in mind are provided below.

***Recommendation 9***

The composition of skills, experience and knowledge on the new regulator's board should recognise its role in setting accounting and auditing standards for public benefit entities. Failing to do so risks the regulator not recognising the impact of its standard setting activities on this sector and not fully understanding the different user needs of all those entities applying its standards.

The FRC and its predecessors have recognised the differences between the private sector and public benefit entity sector, and the need for additional guidance to support entities applying profit-oriented standards in a public benefit entity context. We consider that this should be a factor reflected in the appointment of the new regulator's board. We believe the current membership of the FRC's board does not give sufficient attention to its broader role beyond setting standards for private sector entities.

The board's membership should include individuals who understand the issues impacting public benefit entities, either through a detailed knowledge of, or professional expertise in, the sector. Members' personal interests in the sector should not be relied on to inform the board and such reliance risks not-for-profit issues being overlooked. An understanding of these issues could be supplemented by wider engagement with preparers, auditors and users of financial reports in the sector. This could be achieved by revising the FRC's existing committee and panel structure (see below).

***Recommendation 13***

We believe that the new regulator's committees and panels should have an understanding of the issues faced by the broad range of entities applying its standards. In our view, the FRC's standard setting role for public benefit entities could be better reflected in the existing structure of its committees and panels.

As with its board, we believe the membership of the FRC's current committees and panels does not give sufficient attention to its role beyond that of setting standards for private sector business entities. This has contributed towards the development of financial standards that focus on the private sector and have unintended consequences for public benefit entities.

This is illustrated by the provisions for smaller charities in the current UK financial reporting framework.

The recent implementation of the EU Accounting Directive changes in the UK resulted in new and revised UK accounting standards for small and micro-entities. The changes introduced two new reporting frameworks for small and micro-entities, which were designed with private for-profit entities in mind, and withdrew the previous Financial Reporting Standard for Smaller Entities (FRSSE). As a consequence, the Charities SORP based on the FRSSE had to be withdrawn. However, neither of the new frameworks have yet provided a viable alternative for small charities which have a higher need for accountability than equivalent sized for-profit entities. This is also due to the legal requirements which apply to charity reporting.

In the absence of a suitable solution for charities, this has resulted in UK charities being required to prepare financial statements in accordance with the full accounting requirements of FRS 102. This is despite the vast majority of UK charities meeting the size criteria to apply the new frameworks for small and micro-entities. As a consequence, the accounts of many charities are now considered to be excessively long and contain disclosures designed with for-profit entities in mind which are, in our view, disproportionate or of limited benefit to users of charity accounts. The withdrawal of the FRSSE and the changes to the regime for smaller entities have created a reporting framework which offers little scope for simplification for small charities. As a result, the framework is not sympathetic and unsuited to small charities which make up the vast majority of the UK charity sector.

A greater understanding of the issues impacting public benefit entities can be achieved by engaging individuals who have knowledge and experience of the public benefit entity sector. A number of the FRC's committees and panels include such individuals. However, they are usually few and the membership typically represents the interests of the private sector. As a consequence those with knowledge of, or expertise in, of public benefit entities are in a significant minority.

We believe it is important that this gap in understanding is addressed as part of the review of the existing committee and panel structure. We recommend a committee is formed that works with the regulator in an advisory capacity to ensure that the perspective of the public benefit entity sector is considered in the development of financial reporting standards. This could draw on the previous experience of the Committee on Accounting for Public-Benefit Entities (CAPE) which provided this input to the Accounting Standards Board. CAPE advised the Accounting Standards Board, and its predecessors, on accounting issues for public benefit entities applying UK accounting standards. It made a significant contribution to the development of public benefit entity accounting through the development, for example, of the 'Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting'.

**Q5. How will the change in focus of CRR [Corporate Reporting Review] work to PIEs [Public Interest Entities] affect corporate reporting for non-PIE entities?**

The nature of public benefit entities means the vast majority do not meet the UK's current definition of a Public Interest Entity. As a consequence, the proposal to limit the new regulator's CRR work to PIEs will remove almost all public benefit entities from the scope of these review. We are concerned that restriction of CRR work to PIEs will result in a restriction in the oversight of public benefit entities.

The public benefit entity sector represents the core of civil society. The NCVO almanac provides an estimate of the economic impact and contribution made by the sector. It indicates that its workforce is comparable with that of the UK construction industry, with public benefit entities representing major employers. Within the sector, financial reporting plays an important role in enhancing accountability and supporting the building of public trust and confidence. Instances of poor reporting practice, however isolated, have the potential to inflict considerable damage, which include undermining the sector's ability to access funding.

The financial reporting standards set by the FRC are applicable to a range of entities. This should be reflected in the ambit of the new regulator's review work. We believe that limiting its scope to PIEs leads to a less demanding regime for preparers and auditors of non-PIEs. It is therefore important that the new regulator has responsibility for the review of non-PIE financial reports.

Should the regulator's CRR work not be broadened, it should seek to bridge the potential gap in oversight .We recommend that the new regulator's monitoring and review work includes measures that support robust and reliable reporting in the UK public benefit entity sector. This could be done by working closely with charity regulators. For example, the regulator could actively report adverse trends it observes in reporting and accounting with the UK charity regulators. This intelligence could then be used to inform the charity regulators own monitoring and review work.

**Q6. What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?**

The proposed service aims to provide assistance to entities that want to prepare accounts compliant with accounting standards. As the service will operate on a charged-for basis, we expect that it would be predominately used by very large companies.

Novel and contentious matters can be encountered by any type of entity applying accounting standards, including charities. The majority of charities will be unlikely to use the service as a consequence of its costs. In our experience, novel and contentious issues are encountered by charities applying accounting standards. This reflects the special factors and transactions undertaken in the charity sector which are not addressed in FRC standards. This is the principal reason for the development of the Charities SORP which supplements accounting standards applicable to charities.

We believe there is a risk that the 'pre-clearance' service may be only accessible to the very largest companies. This could contribute towards a gap between the assistance available to entities out with this category.

We recommend that the service be developed to allow the regulator to act in the public interest. This could ensure that where an issue is of wider application, the fact pattern and advised treatment is fed into the future development of the relevant standards and accompanying guidance. Whilst these issues may reflect circumstances specific to an individual entity, the underlying issues may be prevalent in other entities within that sector.

For example, an entity applying FRS 102 may receive advice on a complex accounting treatment through the 'pre-clearance' procedure which is of relevance to other entities. In such cases, publishing the fact pattern and advised treatment would be of benefit to others applying the standard. This would also benefit the SORP-making bodies in their development of guidance on the application of accounting standards.

**Q7. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?**

Comments on those considerations which should be borne in mind are provided below.

***Recommendation 23***

We support the new regulator engaging more meaningfully with users about their information needs. In our view, a wider appreciation of the views of users of annual reports and accounts will help inform the development of financial reporting standards.

The recommendation includes a specific reference to the information needs of asset owners. We understand this to be framed around corporate reporting where the primary focus is on the information disclosed by a company to its investors and lenders. However, it is important that the new regulator acknowledges that the reporting standards it will set are applicable to other entities in addition to companies. The regulator must take a broad perspective in taking forward this recommendation, and include the needs of those users of the reports and accounts of public benefit entities. This will require a focus which extends beyond investors as the principal users of annual reports and accounts.

This is especially relevant in the charity sector, where charities annual reports and accounts are required to meet the needs of a wide range of users. This includes current and potential funders, donors and financial supporters. These users have different information needs compared to those that meet the definition of 'asset owners' in a company.

The regulator's approach to engagement should recognise the differences between the private sector and public benefit entity sector. This could be done by taking a different approach and carrying out a separate engagement exercise specifically focused on public benefit entities. This would help to ensure these users' information needs are identified and the statutory reporting framework is developed in a way that recognises their interests.

We support the regulator's promotion of brevity and comprehensibility in accounts and reports. Charities currently prepare their financial statements in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland, being FRS 102. Although the Charities SORP does require additional disclosures in the public interest, in our view, the standard has not encouraged brevity and comprehensibility in charity's annual accounts. We will be looking at the SORP's requirements again to see if we can simplify or remove elements of charity specific reporting, however most disclosures arise from applying FRS 102.

We believe the notes to the accounts do not always address matters of real interest to stakeholders. They can clutter the annual accounts with technical disclosures rather than decision-useful information. Research evidence from previous consultation exercises carried out by the Charities SORP-making body has cited the requirements covering comparative information, defined benefit pension plans and financial instruments as contributing towards this 'clutter' in charity accounts. We recommend the relevance of these specific disclosures are considered in the context of promoting brevity in financial reporting.

The current reporting standards have also resulted in significantly more transactions now being classed as financial instruments. Depending on the nature of the transaction, its measurement and presentation may require a discounted cash flow calculation to be

prepared. The intention of discounting is to distinguish any element of financing costs in a transaction, therefore whilst the rate of return on capital or financing costs is an issue for investors, its application to charities is of questionable value. This has meant account preparers now have to discount transactions such as trade debtors, leases, ordinary shares and loans. This has resulted in preparers having to navigate and apply complex requirements in order to account for otherwise simple transactions. In addition, the disclosures associated with these transactions are also complex and employ technical language. In our view, this has raised barriers for users to understand the accounts. This is exacerbated for charities where the financial understanding of users of accounts can vary significantly. This is also exacerbated for smaller charities, who have to apply the full requirements of FRS 102 in the preparation of their accounts (as referred to in our response to Question 4). Charities are unable to apply the reporting frameworks for small and micro- entities, which include simplified accounting treatments and reduced disclosures for these transactions.

***Recommendations 37 & 38***

We welcome the proposals to review and enhance the sanctions available to the regulator. The new regulator needs to have appropriate sanctions for cases of misconduct or poor practice.

**Q8. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?**

Comments on those considerations which should be borne in mind are provided below.

***Recommendation 45***

The proposal to introduce a 'duty of alert' for auditors is comparable with the current statutory duty in the UK for external auditors to report matters of material significance to the relevant charity regulator. This is a longstanding duty that provides valuable information to the UK charity regulators and allows them to engage more promptly with charities in difficulty.

The UK charity regulators have jointly issued guidance for auditors and independent examiners on this duty. This includes a list of matters that are always considered reportable that is periodically reviewed and updated in light of developing themes and regulatory experience. The list of matters of material significance includes when an auditor provides an audit report where there is an emphasis of matter or material uncertainty related to going concern. Under charity law, the auditor is required to report such matters to the regulator immediately it comes to the auditor's attention. It is observed that auditors are not required to perform any additional audit work as a result of this duty, nor is the auditor specifically required to seek out reportable matters.

We believe the duty recognises the vital role that auditors have in supporting the charity regulators to carry out their regulatory functions. However, it is acknowledged that whilst auditors play a part in helping to ensure the effective accountability of trustees and management, it is the responsibility of trustees and senior management to effectively manage and operate their charity. As a consequence, auditors tend to be involved after an event and not at the point decisions are made. This should be acknowledged in the introduction of the auditor's 'duty to alert'. Whilst the duty has the potential to act as a useful warning tool, its retrospective focus means it should form one part of the regulator's market intelligence function.

The requirement to report matters of material significance does not remove the duty of an auditor to report matters to other regulators (where appropriate). Similarly, where the matter is reportable to another regulator or agency, the duty for an auditor to report to the relevant charity regulator remains. Therefore, we recommend that the new regulator considers the relationship between the 'duty to alert' and other similar duties required of auditors. It is important that auditors' reporting duties are clearly defined and their interaction with other requirements are distinct. For example, the duties of auditors of charitable companies will require careful consideration in order to reduce dual reporting and to mitigate the risk of auditors failing to notify either the relevant charity regulator or the new regulator.

***Recommendation 51***

We support the need for proportionality in the consideration of a strengthened framework for internal financial controls. We agree that this is a detailed and complicated issue, where further consultation is needed.

A charity's internal controls play an essential role in helping trustees meet their legal responsibilities for safeguarding the organisation's assets and ensuring the proper application of resources. Internal controls are important in charities of all sizes. However, similar to companies, the nature and type of controls will vary depending upon

the size and complexity of the organisation. Whilst all charities need to protect their assets and get the most from their resources, the controls must be proportionate to the risks involved. Determining what is proportionate requires the use of judgement and experience, and does not lend itself to a formulaic approach. For example, small charities have difficulties in achieving full segregation of duties due to resource constraints. Therefore, trustees have to seek to ensure the controls implemented are proportionate to the specific risks their charity faces.

We recommend that the development of a framework for internal controls gives adequate consideration to its impact on the range of entities applying it. We believe that there is a risk that a 'strengthened' framework based on the US regime will contribute to a prescriptive approach that does not reflect the diversity of those entities required to comply with company law. This could contribute towards increased compliance costs, rather than practical improvements in an entity's overall control environment.