Charity sector developments

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Foreword

Global unrest, political uncertainty and rocketing costs culminating in an official period of recession for the UK has created another difficult year. The post-Covid period has not been the time of recovery that was hoped for.

Consequently, the charity sector continues to face unprecedented demand: families and individuals are increasingly likely to turn to the third sector for support during these difficult times. But charities are being asked to do more with less, alongside increased staff wages, lower grant and donation income and rising costs across the board.

Our 2024 charity development report considers sector risks, financial reporting and audit changes, as well as the broader not-for-profit (NFP) environment.

Charitable income is increasingly unstable: donations are lower, legacies are slightly higher, and grants are failing to keep up with inflation. These factors, combined with high costs and limited additional support from government means that charities are unable to meet high demand on their services with less cash.

Following a period of industrial action and employee dissatisfaction we have seen a tight labour market for a further year. Trends of 'quiet quitting' and other signs of workplace discontent means that employers are needing to think more carefully about how to support their workforce in the longer term. Whilst remuneration is a key factor, career progression and job satisfaction are equally important, and we explore how organisations can 'future proof' their people and culture.

Cyber-attacks on not-for-profit organisations remain an area of increased risk. This year, our report looks at how charities are addressing the problem, and what tools are at their disposal to deter hackers.

Financial reporting and audit remains a fluid and transforming space. We delve into the importance of technology within audit processes, and what the proposed changes to ISA 250 mean for both charities and their auditors. Climate reporting is still a hot topic as we approach 2050, and charities strive to meet their net zero targets. Going concern is still an area of scrutiny, especially through the current economic difficulties. Reverse stress testing is an essential way that trustees can gain comfort over the stretch in their forecasts, ensuring that plans for the next year are robust. Alongside this, we consider the importance of strong reserves and investment policies and how these are the foundations of good governance and financial efficiency.

At the end of March 2024, the FRC issued its final revisions to FRS 102, for periods beginning on or after 1 January 2026. With some key changes to leases and revenue recognition in particular, this will bring some new reporting requirements and changes to accounting policies for charities. We anticipate additional guidance for the sector from the Charity Commission and SORP committee in due course and we will of course provide further updates in future publications.

In the wider NFP environment, we have seen amended guidance for Charitable Incorporated Organisations (CIOs) bringing the model constitutions in line with the requirements of the Charities Act 2022.

A second exposure draft for international NFP accounting standards has also been released. As yet, it is unclear how this reporting framework will impact on UK charities in the future, but a global, comparable framework for the sector is an interesting area of progression.

The full impact of the changing legal and political landscape is hard to predict. With a possible change in government in the UK this year, there may be further legislative changes to grapple with, but at present these remain unknown.

We hope you find this publication informative and if there are any matters that you would like to discuss further, please do not hesitate to get in touch with your Grant Thornton contacts.

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Sector risks

Good vibes only: future proofing your people

People are the lynchpin of any organisation. For charities, the employees and volunteers are absolutely essential to the delivery of charitable aims. But, in a time where employees are empowered to take industrial action against wages and working conditions, flexible working is the new normal, and the traction gained by online trends such as 'Quiet Quitting,' it seems that employers need to work much harder to keep their workforce engaged.

People-centric

Grant Thornton conducted Environmental, Social and Governance (ESG) research in 2023 and found that 74% of business leaders say that prioritising their employees is important.[1] We know that charities are equally, if not more, people-driven, as we know how diverse the third sector is, but there is an increasing skills gap: UK Fundraising reported that more than half of charities had vacancies and of those, 83% were finding it difficult to recruit staff.[2] Whilst this may give rise to upskilling other staff, it can also be detrimental, leading to burnout, increased workload and limited job satisfaction.

Charities are experiencing a difficult financial position insofar as the increasing cost environment is putting pressure on organisations to increase pay scales for their people, but this may be at odds with charitable objectives. There is a real risk that staff will look for employment elsewhere if charities are unable or unwilling to increase wages.

As a result, staff retention is a key area of focus for achieving charitable aims. Salaries are important particularly in the current economic environment, but staff retention relies on an inclusive culture, a sense of belonging and benefits packages that are supportive of individuals at all points in their careers and personal lives. Many employees have a desire to understand their career pathway and know that they will develop and grow with the organisation over time. This might involve reskilling or upskilling employees to meet the areas where business-critical skills are needed. Developing talent within charities will ensure that organisations can be future proof.

Future skills

Effective strategic workforce planning can ensure charities identify existing talent and also requirements for future skills. Solutions needn't be complex. They do, however, require a strategic understanding of the charity's vision and future objectives, collaboration between a central HR or people function and the charity, and a willingness to invest in activity which has long-term benefits for the charity's beneficiaries. Investing in the right skills for the future can reduce the cost of acquiring new skills and new people in the long-term, which improves the agility and resilience of the charity.

AI

The advancement and use of AI (Artificial Intelligence) over the last 18 months has been momentous, infiltrating everyday life. For charities, this technology offers huge opportunities. There is however some resistance and a fear that AI will replace real roles, but this does not have to be the case. As we see it, AI could support charities with day-to-day processing tasks, allowing valued staff to use their time for project work and personal development. The Charity Excellence Framework suggests that AI isn't able to manage people well, so face to face interactions and management roles will continue to be important.[3] In fact, AI could enable charities to deliver more, for example by streamlining fundraising processes, offering online 'chat' support for those in need, and performing some back office data processing functions.

1 ESG snapshot: sustainable transformation | Grant Thornton
2 Charity recruitment crisis taking its toll, study shows - UK Fundraising
3 Charity AI - Impact On Charity Sector Jobs (charityexcellence.co.uk)

Agility, resilience and cost

Understanding these three concepts and how they interact is essential for long term planning and success.

Agility: how well, and how quickly, can the charity adapt to change? A good example of this is flexible working as an outcome of the pandemic which is here to stay – employees demand this as an option and for some roles, this is a new normal. To maintain a competitive edge, charities must continue to use flexibility to ensure that their people are satisfied and attracted to roles. To be effective, managers must learn how to maintain a remote team, appropriate technology infrastructure must be in place and the charity's culture must evolve in order to meet the needs of remote or hybrid workers.

Resilience: how well does the charity absorb current shocks? Looking at the current wage inflation issue, we know that charities with larger workforces are looking at high costs throughout 2023 and 2024 particularly for specialist and highly skilled roles. Investment is required and charities must think strategically about the key roles in the organisation in order to best bolster those areas of skill.

Cost: what is the expense to the charity? Charities need to understand that the expense incurred must be able to deliver longer-term aims and objectives and in some areas this expense is unavoidable. The return on investment must be 'worth it' but the challenge is around having the right skills in the organisation identified to invest in. Additionally, where charities are being asked to 'do more with less,' a higher payroll bill may mean that operations and services have to be scaled back. The Charity Excellence Framework reports a £1bn funding cut across the sector which could lead to service cuts and a disproportionate impact on the most vulnerable people in our society.[4]

Summary

Charities are uniquely placed in that, overall, they have a committed and dedicated workforce who believe in the objectives of the organisation. Once those individuals are found, it is important for charities to show long term support for their employees through appropriate upskilling and career progression, along with attractive and useful benefits packages. The long-term mindset is crucial for charities and being both agile and resilient is deeply important. Over the last few years charities have demonstrated that they are equipped to survive shocks, but it is essential to consolidate those learning and develop clear future strategies.

4 [Charity Cost Of Living Crisis £1bn Funding Cuts Report (charityexcellence.co.uk)]

Effective governance: managing related parties

Related parties are an important area of focus for those charged with governance as they manage the best interest of their charities. This is a key area that has been a point of focus for the Charity Commission recently, as many investigations have been launched into charities who have engaged in conflicting transactions with related parties. The definition of "related parties" is extensive, and encompasses a wide range of persons – many of which those charged with governance and management often do not realise meet the definition.

A common misconception is that related parties only include subsidiaries of a charity, trustees or key management personnel. However, the definition of "related party" is not only applicable to such persons and entities but many more as well. The Charities SORP (FRS 102) defines related parties as, "those persons or entities that are closely connected to the reporting charity or its trustees". The following are classified as related parties:

- Any charity trustee and custodian trustee of the charity;
- A person who is the donor of any land to the charity;
- Any person who is:
  - A child, parent, grandchild, grandparent, brother or sister of any such trustee or donor of land;
  - An officer, agent, or a member of key management personnel of the charity;
  - The spouse or civil partner of any of the above persons;
  - Carrying on business in partnership with any of the above persons;
  - A person or a close member of that person's family, which has control or joint control over the reporting charity; and
  - A person or a close member of that person's family, who has significant influence over the reporting charity.

A person's spouse, children, stepchildren, illegitimate child of that person's spouse or domestic partner, dependents and person's domestic partner who lives with them as husband or wife or in an equivalent relationship are all considered a "close member of a person's family", and therefore will meet the definition of a related party.

As noted above, there are several types of individuals that management and those charged with governance must consider when identifying related parties with the charity and considering when a transaction could be perceived as a conflict of interest. Trustees are responsible for the governance of the charity, and ultimately responsible for considering whether certain transactions of the charity result in a conflict of interest.

Issues can arise from transactions that result in financial gains, or are driven by perceived loyalties. These can lead to conflicts of interest.

Financial conflicts occur when those charged with governance or management, or an organisation of which they have control, receive a financial advantage (for example, cash) as a result of their decision making. The Charity Commission outlines the following examples of financial conflicts:

- Paying a trustee for performing their trustee role;
- Employing or paying a trustee, or a trustee's relative, to perform work at the charity;
- Selling, loaning or leasing charity assets to a trustee;
- Buying, borrowing or leasing charity assets from a trustee; and
- Buying goods from a business owned by a trustee.

A trustee of a charity becoming an employee, and receiving compensation is a common example of a related party transaction that creates a financial conflict. There must be sufficient evidence maintained by the trustees as to whether such compensation has been appropriately authorised. In such instances, consultation is required with the Charity Commission to ensure permission has been obtained to compensate a trustee for their employment. Additionally, such permission must also be obtained if the charity is planning to make bonuses, or provide other similar compensation, to a trustee. Charities have the legal duty to seek authority for such payments from the Charity Commission.

Loyalty conflicts do not relate to receiving cash, earning money or something else of value. A loyalty conflict occurs when a trustee may make a decision that is not in the best interest for the charity. The Charity Commission outlines the following examples of loyalty conflicts:

- Making decisions on behalf of the charity that involves a person or organisation that has a link to the trustee, including:
  - A trustee's employer;
  - Another charity of which they are a trustee; and
  - The trustee's relatives or friends.

Scenarios like these can easily be perceived negatively due to the conflict of interest, which arises from the transaction. Not only does this make it important for the trustees to maintain accurate records for their decision-making and their steps to identify, manage and avoid any conflicts of interest as a Board, but this is a legal requirement of the charity when registered with the Charity Commission. Methods to maintain such records include:

- Accurate minute taking that reflects the conversations of which the trustees have engaged in;
- A thorough process to identify, declare, manage, and keep records of related parties and conflicts of interest; and
- A policy for trustees which outlines when conflicts of interest normally occur, how to declare the conflicts of interest, and what all trustees should do about any conflicts.

Additionally, trustees must also consider the rules outlined in the charity's governing document, the law and the Charity Commission and ensure the decision-making made by the trustees adhere to such requirements.

Management and those charged with governance should be putting procedures in place to ensure listings of related parties and other conflicts of interest are maintained, and updated on a routine basis to ensure that timely information is available to confirm no inappropriate transactions are taking place with related parties.

Ultimately, those charged with governance are responsible for overseeing the charity and as part of this oversight, ensuring that any related party transactions have been adequately reported to the Charity Commission, where required and ensuring that there are adequate procedures in place to identify related parties and maintain accurate records of all related parties of trustees and those charged with governance.

Sources and articles used:
Education charity given official warning over 'breaches of trust' (civilsociety.co.uk)
Managing conflicts of interest in a charity - GOV.UK (www.gov.uk)
Charities-sorp-frs102-2019a.pdf (publishing.service.gov.uk)

Cyber risk: the dilemma for charities

Cyber security continues to be an ongoing area of risk for all organisations, and increasingly for charities.

In January 2024, Grant Thornton held a virtual discussion with Chairs of Audit Committees (or equivalent), highlighting cyber threats as a key risk area and cause of concern. Please refer to our full write up of the event, here.

One of the themes arising from the discussion was the fact that charities may feel reluctant to spend resources on cyber security enhancements, rather than on front line charitable work. Cyber security is a growing area of cost which, frankly, many charities cannot afford to invest in during these challenging economic times.

The dilemma for charities is therefore whether they leave themselves potentially vulnerable to cyber-attack or invest in protecting themselves against a faceless threat that may not ever present itself.

Costs

Cyber insurance is more widely available than ever before. The average cost of a cyber breach is up to £4.5m and so protection against attack is an important consideration for many organisations.[5] Statista reports that almost 73% of businesses worldwide were affected by a ransomware attack in 2023 and so the threat is real.[6]

Unlike buildings or vehicle insurance however, there is a much higher onus on the charity applying for insurance to prove to the provider that they are responsible and have sufficient practices in place to make them eligible for protection. This often involves extensive questionnaires on application which requires charities to demonstrate that they are training their staff on cyber risks and have Multi-Factor Authentication (MFA) on their digital devices, as a minimum. Whilst this process itself may be onerous, for smaller charities who do not already have strong practices in place, insurance can be unobtainable.

Payment for cyber insurance is arguably at odds with charitable activities: whilst important to safeguard data, there is no discernible advantage to beneficiaries and it is potentially an excess cost that does not further aims. Given that there is no limit to the possible costs of cyber protection, and future escalation of costs, this may be difficult to forecast.

Ethics

Charities, by their very nature, are expected to be ethical organisations, making, and taking decisions based on the best results for their beneficiaries. So, in the event that a charity was subject to a cyber incident, is there an ethical obligation to 'do the right thing', even at the detriment of funds?

Ransomware is a type of cyber attack where hackers steal data and hold it at ransom until payment is made. The costs incurred to safely retrieve data can be many millions of pounds as we reported in last years' sector report. On one hand, safely retrieving data (despite the cost) is thought to be the more secure option and safeguards the returned data. On the other hand, paying the ransom may be cheaper and a far quicker way of returning to normal functionality.

Charities find themselves in a complex position where their charitable objectives mean that payment of a ransom is simply not allowed. Further, paying a ransom may, inadvertently, lead to financial support of organised crime or terror activities and create significant reputational damage. Any cyber-attack, whilst faceless, is a criminal act and any payments may reinforce to cyber criminals that they can exploit organisations for actual financial gain.

Furthermore, payment of a ransom may be in breach of a charity's articles and therefore be a reportable matter to the Charity Commission. However, each charity would need to consider their situation and make a decision which is appropriate for them: if data were being held ransom in a care organisation, the board may consider a ransom payment in order to save lives and protect the people in its care. In any event, regular and thorough communication with the regulator would be essential for a charity being held to ransom to allow for a cohesive resolution.

Summary

Hackers attack charities because of potential vulnerabilities in security and likelihood of financial gain, particularly from those organisations that hold donor data. There is a reluctance from charitable organisations to spend resources (operational and financial) on security, particularly where it may be at odds with objectives. Ethics is also a key factor and charities must think carefully about their approach to cyber risk, balancing possible support of criminality with a sense of responsibility and good financial planning. As threats evolve in a rapidly changing digital world, charities must consider carefully their long-term cyber policies.

5 Is Cyber Insurance Worth The Rising Cost?: The REC
6 Global firms targeted by ransomware 2023 | Statista

Uncertainties in the economic climate and charitable funding

Charities, as for everyone else, continue to operate and adapt in a climate of ongoing economic pressures and uncertainty. Inflation has fallen from a 41 year high in November 2022 of 11.1% to 3.4% in February 2024.[7] This remains high compared to historic levels and has driven up interest rates, contributed to the cost-of-living crisis and created an expectation for higher wage increases. More people are in need which is increasing the demand for charitable help. One would expect with the financial pressures on people that charities would be experiencing a squeeze in giving but the data suggests this may not be the case. Donations and legacy giving appear to be holding up, if not increasing, although the giving of voluntary time is falling.

The use of food banks is one barometer of the levels of poverty and need. The year to March 2023 saw close to 3 million emergency food parcels distributed by food banks in the Trussell Trust network, the most parcels ever distributed by the network in a year.[8] The next six months through to September 2023 saw a further 16% increase on the year before.

Charitable legacy giving is an area the Government has been encouraging and is, perhaps contrary to expectations, increasing. Legacy Foresight, a research and consultancy organisation, estimate that charity legacy income in the year to March 2023 increased 6.5% to nearly £4bn.[3] Their finding was that the value of value of legacy gifts had increased although the number of legacies had remained largely the same. The increase could therefore be due to increasing investment portfolio values and house prices rather than an increase in the number of people including charities in their wills, which would lead to future patterns being uncertain depending on house prices and investments in the future. The Government encouraged legacy giving to charities in 2012 when it created an overall reduced 36% rate of inheritance tax if the person gives at least 10% of their net estate to charity, which charities would do well to continue reminding their supporters of. The Government has also simplified the giving of legacies to charities in the Charities Act 2022 where land is involved.

Charity donations also do not appear to have fallen during the cost of living crisis according to the latest data. The Charities Aid Foundation (CAF) UK Giving Report 2023 showed a similar pattern of giving in 2022 as we note for legacies above. The total amount of donations, not including legacies, was estimated by CAF to be £12.7bn in 2022, an increase of £2bn from £10.7bn in 2021. The number of people giving however remained the same and for most of the months in 2022 was a decrease in the year before.

Volunteering however has seen a decrease and there has been an expectation for increased wages by employed staff. In the CAF UK Giving Report 2023 the proportion of people who had reported to have volunteered in 2022[4] was 13%, compared to 16% in 2018 before the pandemic, representing around 1.6 million fewer people. With higher inflation recently, there has also been higher wage increase pressures on charities.

In summary, charitable funding including legacies has held up in the current economic climate and actually increased but the number of people who are able to give is decreasing and there are uncertainties regarding the stability of future income. It is possible there will be a further lagged impact on the sector from the cost of living crisis, particularly as this continues to be a longer term macroeconomic matter. Charities are therefore advised to continue to monitor income and expenditure carefully, keep updated realistic forecasts and maintain appropriate policies on funds and investments.

7 Consumer price inflation - Office for National Statistics (ons.gov.uk)
8 Latest Stats - The Trussell Trust
9 Legacy Market Review 2023 - Legacy Futures
10 UK Giving 2023 | A study of charitable giving in the UK | CAF (cafonline.org)

Financial reporting and audit

FRC thematic review of climate related matters and targets

Climate reporting is mandatory for charitable companies which are defined as large companies, where the entity meets two of the following criteria:

- Turnover of more than £36m
- Total assets of more than £18m; or
- More than 250 employees

Where a charitable company meets these criteria, they will be required to include climate reporting within their financial statements.

In July 2023 the Financial Reporting Council (FRC) released their thematic review of climate related matters and targets following consideration of disclosures of twenty UK premium and standard listed companies. Although this was not a review of charity financial statements there are some best practice points noted below which can be taken into consideration when preparing disclosures for climate reporting.

Due to the volume of information which requires disclosure, it can be challenging to present this clearly within the Trustees' report so that the stakeholders can easily locate the most relevant information presented. The FRC note that there are 4 points to give effective communication:

- Entity specific
- Clear, concise and understandable
- Clutter free and relevant
- Comparable

The main areas where the FRC see room for further improvement, which may be relevant to charitable entities are:

- the definition and reporting of entity-specific metrics and targets, beyond headline 'net zero' statements;
- better linkage between entities climate-related metrics and targets and the risks and opportunities to which they relate; and
- the explanation of year-on-year movements in metrics and performance against targets.

Climate related targets

When disclosing climate related targets, entities are expected to:

- Explain what 'net zero' or 'carbon neutrality' terms mean, in the context of the entity, ensuring that disclosures about such commitments are not misleading.
- Provide explanations of targets, including relevant information such as the time period, reporting boundaries, the emissions scopes covered and any metrics used to measure them.
- Explain areas of significant challenges or uncertainties, such as new technology, required to meet targets.
- Ensure that linkages between targets are explained if a number of targets need to be met in order to achieve an overall objective.
- Provide comparative information for all metrics alongside current reporting to enable performance against the target to be assessed. If any updates are made to targets, such as restatements or updates to baselines, these should be disclosed and explained.

The importance of IT audit: enhancing efficiency and accountability

If your charity is subject to audit, you will recall that in the last couple of years we have had to undertake additional audit work on IT. This was following the revision of a key Auditing Standard in 2020, ISA 315 'Identifying and assessing the risks of material misstatement'. A significant area of revision for ISA 315 was in the audit requirements around IT and this is due to an appreciation of the increasing dependence on it. We trust the data and reports that are generated by our computer systems more and more.

The recent high profile case surrounding the Post Office and its Horizon system is a good example of data being trusted, this time at the expense of sub-post masters. We will consider how the new requirements of ISA 315 (revised) can help charities and their auditors to better understand the mechanics of IT infrastructure, how this impacts on the financial systems and where vulnerabilities can be identified. To begin to answer this question, we first need to understand the revised requirements of the standard. We will also note some key audit findings we have identified from detailed IT work.

What is new for IT from ISA 315 (revised) is that the breadth of IT environmental understanding and the level of work required to evaluate the design and implementation of IT General Controls have both greatly increased.

IT General Controls: controls over an organisation's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information.

The requirement to understand the IT environment is in ISA 315.25 and expanded in sections A140 – A143. **"The auditor's understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT" (A140).**

This requires an understanding of the IT applications which are, in simple terms, the computer programs in use. Further, the standard requires an understanding of the IT infrastructure which supports the applications and comprise the network, operating systems, and databases and their related hardware and software. In understanding the IT environment, it is necessary to understand when and how changes are made too. **"Changes in the flow of transactions, or information within the information system may result from program changes to IT applications, or direct changes to data in databases involved in processing, or storing those transactions or information" (A142).**

The other IT element ISA 315 (revised) develops is the work on evaluating the design and implementation of IT General Controls. This is in ISA 315.26 and expanded in sections A166 – A174. The requirement is to understand **"the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks may affect" (A166).**

There may be IT risks relating to payroll for example, leading to staff overpayments, fictitious employees, or risks relating to any other business process subject to the use of IT. The auditor is then to understand and evaluate the general IT controls that are intended to mitigate the risks, whether the controls are appropriately designed and have been implemented. Examples of such controls include access to administer security to the application and supporting infrastructure being appropriately restricted and segregated or access to develop and promote program changes.

The financial statements audit team are usually the ones who gain the understanding and evaluate the controls, but there are of course organisations where the IT systems are too complex and the specialist IT team perform the work. A171 states: **"When an entity has greater complexity in its IT environment, identifying the IT applications and other aspects of the IT environment, determining the related risks arising from the use of IT, and identifying general IT controls is likely to require the involvement of team members with specialized skills in IT. Such involvement is likely to be essential, and may need to be extensive, for complex IT environments."**

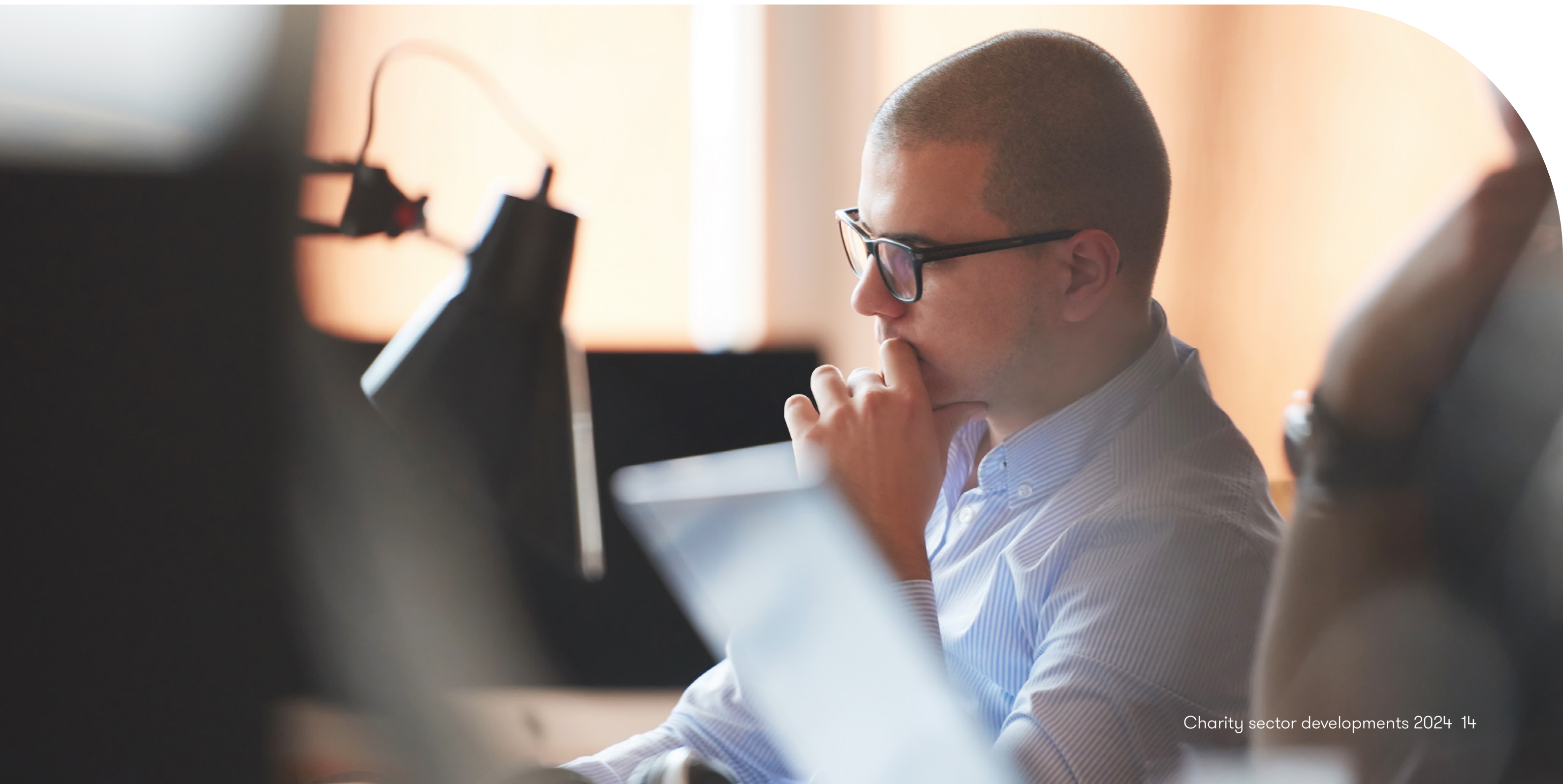
Revised procedures since introducing ISA 315 (revised) have led to a more in depth understanding of the controls and procedures applied to the IT systems at the charities we audit. From this work, we have identified some common themes which are important for all organisations to consider:

- Individuals with administrator access to key finance applications have been found to be members of the finance team
- Individuals with administrator access to key finance applications but who are outside the finance team (such as the IT team) have had the ability to (and in some cases do) post journals

Both these scenarios carry a risk. Individuals with administrator rights are able to access all parts of the IT applications and so are able to change programs or master files that could be undetected and impact on the financial records. Those with administrator rights are also able to add or remove users for each application. An important control for the IT systems is that there is a segregation of duties and different people have the privileged access rights meaning that those who maintain the IT systems are not the same people as those who manage the finance systems. If there is an overlap, this is likely to be a control deficiency and it exposes the charity to increased risk.

Linked to this, another IT control we have found identified as weak, or in some cases, not in place at all, is a regular review of the log showing IT access rights and activity of those with these rights. This is helpful to ensure only the appropriate people have the access and that the login is being used only for appropriate and expected purposes. An additional level of control here is to identify an independent person to regularly review the system log to ensure only appropriate activity is taking place.

Given all of the attention that the Post Office story has had, it is interesting to think about whether or not additional procedures around IT, such as those required by ISA 315 (revised) would have identified the issues with the Horizon program much sooner. As far as we understand the circumstances, the problem with the Post Office IT system was not one of a lack of the expected controls within the organisation, but rather with access to the system by those who provided, operated, and managed the software. Given the detail and complexity of the case, it is unlikely that ISA 315 (revised) would have had any impact, and a more forensic approach was needed to understand the difficulties with Horizon fully. With the revised standard, however, audit is increasingly focusing on IT, recognising that it is becoming more and more intrinsic to the information system. The risks from IT have increased, so it is essential that organisations and their auditors take appropriate steps to safeguard information.



Going concern reverse stress tests: preparing for the unpredictable

Charities have demonstrated resilience since COVID-19 emerging in 2020, and this resilience carries on as charities continue to be in a position of having to address a difficult landscape for operations. Charities work hard to deliver their initiatives and support to their beneficiaries, but they have been continuously affected by economic pressures. As charities work to navigate these challenges, they must consider how such economic factors will impact their viability as they prepare their going concern assessments for their annual financial statements.

Charities are no different from other limited companies when it comes to the requirement to prepare their assessment as to whether they have ability to adopt the going concern basis of accounting and will continue their operations for the foreseeable future. As part of this process, those charged with governance, including trustees or directors of the charity, must prepare an assessment for a period of at least twelve months from the signing date of their financial statements. Twelve months from the signing date of the financial statements is the minimum review period, and a if a key event is due to happen shortly after this period (for example, a loan or revolving credit facility coming for renewal), management must extend their going concern assessment period to include this key event.

Management must begin by outlining the following considerations within their assessment:

- **The process followed to make their assessment;**
- **The assumptions on which the assessment is based; and**
- **Management's plans for future actions.**

In order to support their going concern assessment and the assumptions used within their going concern assessment, the trustees and management should also include:

- **A budget and detailed monthly cash flow forecast, considering factors such as:**
  - Availability of funding (i.e. monthly management accounts, latest bank balances, any facility and funding agreements)
  - The economic environment
  - Future plans and key events
  - Net liabilities
  - Indications of withdrawal of financial support from lenders
  - Operating losses
  - Inability to pay creditors on due dates
- **A reverse stress test**

Trustees and management are generally familiar with the budget, monthly cash flow forecast requirements and risk factors stated above that could affect their going concern assessment. However, the area generally requiring further documentation by those charged with governance is the reverse stress test.

While COVID-19 identified the requirement for charities to undergo reverse stress testing as part of their going concern assessment, the reverse stress test continues to be an important aspect of assessing the charity's going concern as charities continue to experience significant impacts from the current macroeconomic environment.

The reverse stress test is an important exercise for charities to undertake as part of their going concern assessment. The reverse stress test considers when management's cash flow forecast or going concern model used in their forecast will "break", which means when the charity will run out of cash or experience other types of cash flow issues, when their operations will no longer become viable or when any loan covenants are breached. A reverse stress test needs to be considered for each element, however, it is likely that one element may be more sensitive than another, which could still give rise to a material uncertainty. The reverse stress test begins with the base case, and applies one or more scenarios into the cash flow forecast or model, until the point is reached where the model breaks. The reverse stress test requires charities to consider what it would take for their charity to fail, what event would lead to this outcome and what mitigations could take place to ensure such a scenario does not occur. As a reminder, management should tailor these scenarios to consider the specific risks associated with their charity and their charity's operations.

After management has prepared their reverse stress test, they must engage in a second step, which is considering the plausibility of their reverse stress test scenario occurring. This means considering the likelihood of the scenario occurring that breaks the model. This could be identifying whether the scenario is supported by historical experience, and the extent that such a scenario is supported by current macroeconomic conditions and forecasts. Some charities may be in a position where there is no plausible scenario that breaks their model. However, management and those charged with governance must still go through the process of demonstrating that such a scenario does not exist, and clearly document their thought process when drawing such a conclusion. After considering the plausibility of the tailored scenarios within their reverse stress test, management and those charged with governance must consider the mitigating factors that could be applied. If there are mitigating factors available, and applying these mitigating factors would result in the model not breaking, then management is in a position to conclude on their going concern assessment.

Preparing a reverse stress test as part of the charity's going concern assessment helps ensure that the trustees and those charged with governance are preparing a robust going concern assessment and adhering to a strong risk management process for their charity. Additionally, since the reverse stress test requires those charged with governance to consider the risks associated with their charity, it can work as a tool to reveal vulnerabilities to the charity that may not have been clearly identified as part of the "normal" cash flow forecast. This supports the useful nature of the reverse stress test from a risk assessment and risk mitigation perspective.

Summary

The steps of the reverse stress test are as follows:

1. Apply scenarios over key inputs into base case until model "breaks";
2. Consider the plausibility of such a scenario occurring;
3. Identify whether mitigations for such a scenario exist; and
4. Conclude on whether there is uncertainty relating to these mitigations and conclude on whether a material uncertainty exists.

Those charged with governance are encouraged to prepare the reverse stress test as part of their overall going concern assessment to continue to make decisions in the charity's best interest to ensure that the charity can carry out its purpose for the public benefit.

Sources and articles used:
Charity bodies call on Hunt to act after 'no improvement' since autumn statement (civilsociety.co.uk)
Coronavirus (COVID-19): Introducing reverse stress testing | ICAEW

Increasing resilience through reserves and investment policies

Trustees are responsible for setting appropriate short-, medium- and long-term aims and objectives for their charities and a fundamental part of this is selecting a viable reserves policy, and where required, a robust investment strategy.

In summer 2023, Grant Thornton held a virtual discussion with Chairs of Audit Committees (or equivalent), examining how demand on charities in a challenging economic environment affects reserves. Combined with the emerging importance of ethical investments and need for strong financial returns, reserves and investment policies often go hand in hand. Please refer to our full write up of the event, here.

The discussion highlighted some interesting areas where more consideration may be required, particularly around climate factors and variance between organisations in the way policies are chosen. Six months on, we build on these topics.

Sustainability

Our discussion suggested that many charities did not consider climate change to be a key consideration when setting reserves and investment strategies. Participants suggested that there were more pressing, immediate risks to their beneficiaries (such as health or financial concerns) which meant that environmental responsibility did not take precedence.

The FRC's Materiality Mindset report[11] highlighted that sustainability matters are, for some organisations, highly important and indeed material to the finacial statements. Whilst this may not be the case for the majority of charities, who do not have the resources to carry out far-reaching sustainability impact reports , environmental change is a key area of risk and one which demands attention. However, with increasing disclosure requirements and a focus on the third sector to demonstrate a leading role in climate action, more charities will need to consider their environmental sustainability. Charities exist to 'prevent harm' and environmental decision making can be harmful to any and all beneficiaries. We are seeing more reports of charities setting aside reserves to specifically pursue sustainability projects such as investment in new boilers, lighting and building materials. Even though these projects may be costly, it is apparent that charities are beginning to invest in environmentally friendly measures and allocating reserves to specifically address these projects.

A risk based approach

Our roundtable discussion also highlighted that charities are moving away from a '3-6-month expenditure' reserves policy, and towards a risk-based approach. Charities are beginning to focus more on their specific circumstances to determine the level of reserves that is appropriate for their future needs. The purpose of reserves is to help mitigate against and manage risks and sector resilience over the last few years shows that reserves policies have been sufficiently robust to deal with the shocks from Covid-19 and the cost-of-living crisis. Charities should closely analyse financial risks to identify the level of reserves needed. Whilst this is easier said than done, and predictions of impactful macro-economic factors may be impossible to accurately judge, a holistic approach to reserves policy setting is needed.

The Charity Commission updated their reserves policy guidance in June 2023 and highlighted the need to set a reserves policy in line with the overarching strategic objectives of the organisation. One of the key steps in planning a policy is to review income sources and identify those which are subject to instability or fluctuations which may materially impact income. Stable or predictable income streams may reduce the need for larger reserves balances, however current economic conditions mean that some historically reliable income streams are fluctuating. We have heard reports that legacy income is dwindling due to donors being less financially comfortable and more generally, everyday donors are reducing their support due to individual pressures arising from the cost-of-living crisis.

Investments

Ethical investing is an area which goes hand-in-hand with reserves. Charities can now choose to align their investments with ethical, environmental and social goals, even where this may limit financial returns.[12] Our discussion found that some charities are more likely to apply an ethical policy in some areas – for example a charity which supports those with drug and alcohol addiction is less likely to invest in organisations within the alcohol industry. However others noted that potentially 'less ethical' investments in arms or pharmaceuticals often have a far better financial return.

The ICAEW Charity Conference in January 2024 highlighted the importance of ethics within the sector and drew some interesting parallels between ethics and morals, as well as investing and charity choice. The Conference proposed that ethical policies cannot be static and should flex to organisational choices and stances. Factors such as generational expectations, societal norms and fluid beliefs and ideologies mean that a specific ethical approach today may not be appropriate in the next reporting season and charities should be mindful of how they are perceived in society.

11 Materiality in practice: applying a materiality mindset (frc.org.uk)
12 Investing charity money: guidance for trustees (CC14) - GOV.UK (www.gov.uk)

Disclosure omissions

A study by BDO[13] highlighted that some charities are not making appropriate disclosures of their reserves in their annual reports. The research showed that some charities fail to disclose their total reserves levels at the yearend; some do not report their target reserves balance and far fewer are able to articulate the reasons for the difference between the actual reserves and the target.

The Charities SORP section 1.48 requires that the annual report review of reserves should:

- State the amount of total funds held at the end of the reporting period;
- Identify the amount of restricted funds;
- Explain any material designations or commitments at the period end, along with the timings of anticipated expenditure;
- State the amount of free reserves and;
- Compare actuals reserves to the target stated in the policy and explain what steps are to be taken to align them.

Charities are required to comply with SORP reporting requirements and both trustees and management should understand their responsibilities for disclosure. In setting the reserves policy, an understanding of the disclosure requirments should be obtained to enable ease of reporting.

Summary

There are improvements in the way that charities are addressing their policy setting needs and risk and ethics-based approaches are increasingly popular. That being said, disclosure omissions are an area that needs attention and all SORP requirements must be met in producing the annual financial statements. The setting of reserves is never a straightforward process, but charities are looking to risk to assist in their 'bigger picture' needs and the impact of the macroeconomic events in recent years has demonstrated very clearly why a robust policy is needed.

13 Charity Reserves Research: Does the quality of reserves reporting in the charity sector need to change? | Insights - BDO

ISA 250: the consultation

The Financial Reporting Council (FRC) launched a consultation into auditor requirements to detect and report material misstatements from non-compliance with laws and regulations and to clarify instances auditors should report such breaches, and other significant matters, to the relevant regulators. Responses for this consultation closed on 12 January 2024.

Currently, the auditor is responsible for obtaining sufficient appropriate audit evidence regarding compliance with the provisions of direct laws and regulations (those which have a direct effect on the determination of material amounts and disclosures in the financial statements) and for indirect laws and regulations (those which do not have a direct effect on the determination of material amounts and disclosures in the financial statements) the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

The FRC plan to remove the distinction between direct laws and regulations and indirect laws and regulations.

Once the auditor has identified these laws and regulations, they will also be required to:

- determine from the risk assessment and other activities whether there is an indication of a risk of material misstatement to non-compliance with laws and regulations and non-compliance or suspected non-compliance with laws and regulations;
- design and perform further audit procedures which are responsive to the determination above; and
- evaluate whether sufficient appropriate audit evidence obtained indicates there is a material misstatement relating to non-compliance with laws and regulations.

How will this impact the charity sector

Charitable entities are typically more heavily regulated and have charitable activities which may be subject to more specific laws and regulations. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with these laws and regulations. Management are responsible for the preparation of financial statements that give a true and fair view. Accordingly it is necessary, where identified or suspected non-compliance with laws and regulations has occurred which may result in a material misstatement in the financial statements, for management to ensure that the matter is appropriately reflected and/or disclosed in the financial statements.

In order for the auditor to determine an appropriate risk assessment, inquiries may have to be made with management and other individuals throughout the charitable entity to ensure that a sufficient level of detail has been obtained. This may also require further supporting evidence to be provided.

If a material non-compliance was identified (by management or the auditor), additional work would need to be undertaken to establish the nature and consequences of the act, which may include inquiries, understanding status of any investigation and confirmation of significant information with appropriate legal council.

In order for management and auditors to determine an appropriate risk assessment, they may deem it appropriate to engage experts with the appropriate level of knowledge such as lawyers or sector specific specialists.

With the increased level of work required, charitable entities are likely to see an increase in costs, both internally from additional staff time spent to collate and source all information and externally from an increase in audit costs. This increase in efforts and costs may outweigh the perceived benefits obtained from this additional scrutiny.

Other sector developments

The legal and political landscape

It has been another challenging and uncertain year, with ongoing geopolitical turmoil surrounding the Israel-Palestinian conflict in Gaza, as well as the impact of the cost-of-living crisis placing pressures on both businesses and charities alike. Not only has the demand for support and services from community support charities seen a dramatic increase, but there have also been additional challenges placed on charities providing emergency response aid overseas. Not only this, the cost-of-living crisis and record levels of inflation has led to a multitude of strike actions being taken across various industries and sectors, from which charities have not been immune.

Whilst inflation appears to be settling down after the events of last year, the overall outlook for charities remains uncertain and there are a number of things of which not-for-profit organisations should continue to be aware and to keep on their radar. Here's a quick run through some of the more interesting changes that have occurred and coming up on the horizon and their potential impact on organisations operating in the sector.

Charities Act 2022

In our Spring 2023 sector developments bulletin we highlighted some of the more significant changes that had already come into force in respect of the Charities Act 2022, which sought to refine and simplify some of the more onerous elements of the existing 2011 Act. Phase one and phase two of the implementation of the changes have now been completed, with the third phase yet to be implemented. Originally planned for Autumn 2023 and subsequently delayed to Spring 2024, the following provisions are expected to come into effect imminently:

1 Amendment of charitable purposes – these changes are expected to provide a greater level of alignment of regimes between the various types of entities legislated by the Charities Act, namely charitable companies, charitable incorporated organisations (CIOs) and charitable trusts, for the amendment of charitable purposes. Whilst there will be a greater level of consistency in the process between these types of entity, it should be noted that the changes will still be subject to charity commission consent. In addition, organisations should ensure that any proposed amendments have due regard to the nature of the new purposes being in line with the original purposes.

2 Amendment of charitable constitutions – this will allow a brand new statutory power, simplifying the process for charitable trusts and unincorporated associations wishing to amend their constitutions. It will also provide greater clarity and removes uncertainties over the process to be followed. For CIOs, again the process will see a simplification, allowing changes to take effect after the passing of a valid resolution rather than seeking the consent of the charity commission (although it should be noted that consent will still be required in some circumstances).

3 Mergers and acquisitions – it is expected that the new provisions will make the transfer of charity assets easier via a vesting declaration, which can remove the need for the use of "shell charities" to catch any legacies that may be received post-merger.

Full details and guidance on the changes and the implementation plan, including those already in force, can be found on the gov.uk site.[14]

There are still elements of the act that are still under consultation, including those provisions relating to ex-gratia payments. At the end of January the minister for arts and heritage, Lord Parkinson, wrote to the chairman of the Charity Commission to express their proposals to exclude national museums and galleries from the commencement of these provisions. This would mean that such organisations would still need to apply to the Charity Commission for approval of all restitutions made as ex-gratia payments.
In addition to this, Lord Parkinson further proposes that any such payments or restitutions to be made to a recipient outside of the United Kingdom should also be subject to approval and consent from the Charity Commission. A full copy of the open letter can be found on the gov.uk site.[15]

14 Charities Act 2022: implementation plan - GOV.UK (www.gov.uk)
15 DCMS letter to the Charity Commission on the Charities Act 2022 - GOV.UK (www.gov.uk)

Digital Markets, Competition and Consumers Bill

In April last year, the House of Commons introduced a new Bill, which sought to "regulate and increase competition in digital markets". Whilst such a Bill may not, on the face of it, appear to hold any great relevance for the charity sector there have been concerns expressed by various charity experts and professionals about the potential for unintended consequences on the charity sector.

These concerns arise from the intention of the Bill to tackle "subscription traps by imposing new duties on traders", as well as the intention to "give new protections to consumers who make advance payments to consumer saving scheme contracts". Obviously these proposed measures are designed to protect consumers from being caught out by auto-renewals of subscriptions, providing a 14 day "cooling off" period during which the consumer has the right to cancel and receive a refund for any such automatic renewals.

However, as set out in Shoosmiths' article[15] on the Bill published last November, this causes complications for those charitable organisations that operate a membership scheme and are currently able to claim gift aid on those memberships. The implication that such memberships could be subject to the 14 day cooling off period would ultimately mean that these organisations would no longer be able to claim gift aid. In short, there is a risk that the proposed Bill as it currently stands would go against gift aid rules (which require that there is no condition of repayment) and this could have significant impact on these organisations, with losses in gift aid income potentially running into the millions.

As a result of the current lack of clarity within the Bill regarding whether or not charity membership subscriptions fall within its scope, an amendment has since been tabled by conservative peer Lord Mendoza. This proposed amendment adds further wording to Bill that would clarify the position, confirming that membership subscriptions qualifying for gift aid would not be subject to the new rules. This is an amendment that has received both cross-party support as well as backing from the sector and is in the process of being considered alongside the original Bill in the Lords committee stage.

Full details of the Bill itself and its progress through government can be see on the parliament.uk website.[16]

Proposed amendments to the Health and Care Act 2008

The Department of Health and Social Care launched a consultation that ran between September and November last year on proposed changes to Health and Care Act 2008 (Regulated Activities) Regulations 2014. The proposal being put forth was one that sought to remove the statutory requirement to obtain full employment history when appointing health and care volunteers.

This consultation has since closed and the department has now issued its response to the consultation, which was published on the gov.uk website[17] on 18 December 2023. A total of 160 responses were received during the consultation period from a range of organisations and individuals expressing both a professional and a personal view.

As the regulations currently stand, there is a requirement for specific information as set out in Schedule 3 of the regulations to be made available in relation to each person employed for the purposes of carrying on a regulated activity. Such information includes proof of identity, satisfactory evidence of conduct in previous employment as it concerns health or social care, or children or vulnerable adults and a full employment history. The proposal to remove the requirement to obtain a full employment history is to be applied only to volunteer employees in recognition of the need for a different process to be applied in these appointments.

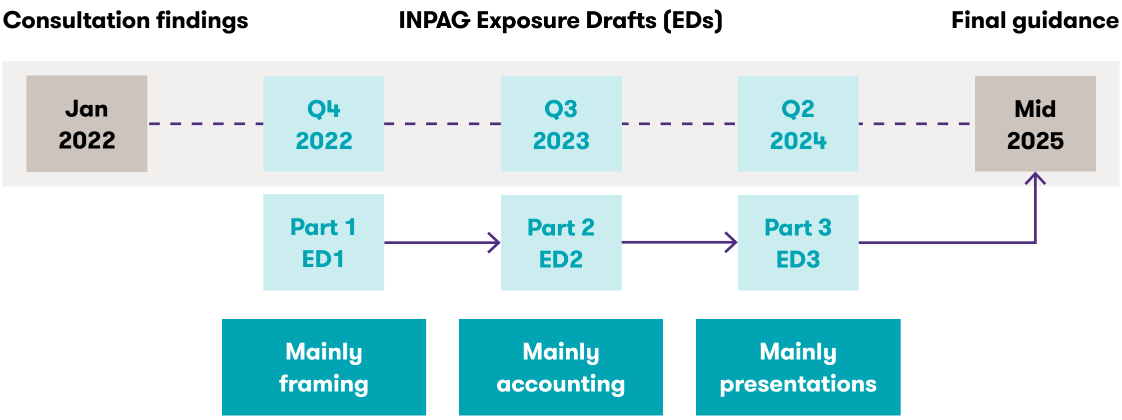
Following the closure of the consultation period, the department has confirmed that it intends to make the proposed amendment, to be enacted via a statutory instrument, and that further work will be undertaken with NHS employers in order to ensure that the changes are reflected in NHS employment standards, as well as ensuring that amendments are made to relevant social care guidance as needed. This will be a welcome change to many organisations in the health and social care sector as it is expected that this will not only remove some of the barriers to volunteering for groups that may legitimately be unable to provide a full employment history, but will also reduce some of the administrative burden associated with appointing service providers and allowing organisations to spend more time and focus on more effective safeguarding measures.

15 Digital Markets, Competition and Consumers Bill: Consumer rights v the Gift Aid regime (shoosmiths.com)
16 Digital Markets, Competition and Consumers Bill - Parliamentary Bills - UK Parliament
17 Consultation response on proposal to remove the statutory requirement for a full employment history when appointing health and care volunteers - GOV.UK (www.gov.uk)

INPAG update: Exposure Draft 2

Last year we highlighted work being undertaken by the International Financial Reporting for Non-Profit Organisations group (IFR4NPO) to develop the world's first internationally applicable financial reporting guidance for Non-Profit Organisations (NPOs). This work had been identified as crucial given that, in many countries, NPOs currently have no guidance or frameworks in place to support the preparation of the financial statements, which is of utmost importance for enabling transparency, accountability and decision making. Whilst some funding organisations have developed their own reporting requirements for NPOs, there is currently no "one size fits all" approach. The work of the IFR4NPO group seeks to ease the burden and complications that arise from having a multitude of different requirements by bringing these requirements together to create a more streamlined and standardised approach to financial reporting for NPOs.

The overall timetable for the exposure drafts and findings is expected to be as follows:



The first exposure draft closed for consultation on 31 March 2023 and the feedback has not yet been incorporated into the second exposure draft. It is expected that some of the original proposals in exposure draft 1 will be refined in the third exposure draft, planned to be released for consultation in Q2 of 2024.

Consultation closed for comments on the second exposure draft on 15 March 2024. This second exposure draft focusses mainly on the core accounting principles that will need to be established in the new guidance. The key areas subject to consultation include:

1 Expenses on Grants and Donations

2 Revenues

3 Inventories

4 Foreign Currency Translation

In addition to these areas, there are some further more minor areas discussed such as the need for inclusion of matters relating to share-based payments and taxation. As with the first exposure draft, these specific matters are set out for comment in the form of 12 main sections with sub questions. As the consultation closed for comment on 15 March 2024, we are hopeful that we will see results of later in the year although this is not anticipated to be incorporated or released prior to the third exposure draft. For more details of the current status of exposure drafts and the overall project, please visit IFR4NPO.

Incorporated organisations: regulatory changes

On 2 January 2013, new regulations came into effect that enabled the creation of Charitable Incorporated Organisations (CIOs). This provided charities with a new possible legal form as an alternative to either being a charitable company or a community interest company, giving charitable organisations the ability to introduce a limited liability for the members of the organisation similar to the limited liability available to companies without having to incorporate and register with Companies House.

The regulations that came into force in 2013 were initially based in the requirements as set out within the Charities Act 2011 (the 2011 Act) with additional new schedules and regulations being issued to complement the basic legal framework set out in the 2011 Act. This enabled the creation of new organisation as CIOs from 2 January 2013, with the ability for existing organisations to convert to CIO status being available from 1 January 2018.

Following the introduction and phased implementation of the Charities Act 2022 (the 2022 Act), it was identified that some of the amendments set out in the 2022 Act needed to be reflected in the regulations for CIOs. With effect from 1 November 2023 The Charities (Charitable Incorporated Organisations) (Constitutions) Regulations 2023 and accompanying schedules came into force, replacing their 2013 counterparts. The main result of these changes has impacted upon the model constitutions for both "foundation" and "association" CIOs.

Impact for new Charitable Incorporated Organisations

Charitable Incorporated Organisations that are submitting a registration application on or after the new regulations come into effect will need to ensure that they prepare the organisation's constitution in line with the new template constitution, which is available from the Charity Commission one the gov.uk[18] website. It is important that the appropriate form of constitution is applied, depending on whether or not the organisation's voting members are restricted to trustees only ("Foundation" CIOs), or if there are other voting members external to the board of trustees ("Association" CIOs).

If the organisation has already prepared their constitution using the old templates, they will need to amend these prior to submitting the registration application. Whilst most of the changes made to the model constitutions are minor and do not have to be reflected, applicants must ensure that the "Amendment to Constitution" clause is updated in accordance with the guidance set out on the gov.uk website.[19]

There are other minor language changes as well, including the addition of the phrase "connected persons" and associated definition and the replacement of references to "company" and "director" with "CIO" and "trustee". Further practical amendments include:

- Amendment of specific clauses in respect of trustee payments in order to align with the changes in the Charities Act 2022;
- Clarifying which alterations of the CIO constitution are regulated by the commission;
- Adding a saving provision for a technical defect in a trustee appointment;
- Adding an optional addition to the association CIO constitution to provide for specific authorised member and connected persons benefits; and
- Clarifying that the requirement to include officer appointments in minutes only applies where there are other office appointment provisions in the constitution.

What should existing Charitable Incorporated Organisations do?

In short, nothing. It should be noted that there is no requirement for existing CIOs to make any amendments to their constitutions. This is because the current wording in the "Amendment to constitution" clause will essentially be overridden by the 2022 Act when phase 3 of the implementation comes into force in early 2024. In addition, the changes made in the 2022 Act in respect of trustee payments do not impact upon the powers granted to CIOs in this regard as the constitutions have always allowed for this within clause 6 of the model constitution.

Full details of all of the changes to specific clauses can be found in the guidance reference table on the gov.uk website[20] along with full copies of the amended regulations and accompanying schedules.

18 Setting up a charity: model governing documents - GOV.UK (www.gov.uk)
19 Guidance: changes to the CIO constitutions in the Regulations - GOV.UK (www.gov.uk)
20 Charity Commission Regulations: Charitable Incorporated Organisations (Constitutions 2023) - GOV.UK (www.gov.uk)

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