CHARITY COMMISSION
FOR ENGLAND AND WALES

Accounts Monitoring Review

Charities with audit reports identifying that they may be in financial difficulty

Summary of findings

How did the Charity Commission identify charities in financial difficulty?

We identified and used audit reports with an 'emphasis of matter' paragraph about 'going concern' as a way of identifying large charities that may be in financial difficulty. We identified and then reviewed the 94 sets of accounts submitted to us in the year ended 31 October 2015 which contained such a paragraph for those charities with a declared annual income of over £1 million.

What were the main concerns highlighted by auditors?

Auditors highlighted either indicators of financial difficulty based on the accounts, such as net current liabilities, or matters affecting the charity's future financial situation, with uncertainties over future funding being the most common concern.

Why were charities in financial difficulty?

The ongoing challenging financial environment was the underlying factor behind many of the charities' stated difficulties. Reductions in income were a major concern for charities that provided charged-for services, such as schools, or that were dependent on public sector grants or contracts, such as those providing leisure and arts services, or that needed to continue raising large amounts of voluntary income. Other charities were dealing with set up or restructuring costs, pension scheme deficits, unplanned overspends or contingent liabilities, such as claims against the charity.

What actions were trustees taking?

The most common response was to generate more income, through increasing the number of people using the charity's services, diversifying sources of income or fundraising. Others concentrated on plans to manage a specific financial risk, such as a pension scheme deficit. The trustees of those charities in most serious difficulty were restructuring their charity's activities or considering winding it up.

How successful have the trustees' actions been?

Fifty-seven charities have now filed a more recent set of audited accounts. The financial positions of 14 charities had improved sufficiently for the auditor not to include an emphasis of matter paragraph in his or her audit report. By contrast, the auditors of 5 other charities consider that they are no longer a going concern. An additional 9 charities have ceased to operate, according to our records.

What action have we taken?

As a result of our scrutiny, we referred and included 5 of the charities into our complementary programme of proactive inspection visits to charities with signs they are in financial distress. We have produced updated regulatory guidance to help the trustees of charities which are facing financial difficulty ('**Managing a charity's finances: planning, managing difficulties and insolvency (CC12)**'). We have contacted the 69 charities in our review that are continuing to operate, and with which we are not currently engaged, to remind them of their duties and responsibilities and provide them with guidance, including a link to the updated version of CC12.

What are the lessons for other charities?

Our review has highlighted the challenges that the difficult financial environment presents for charities and some of their strategies for dealing with them. It has also highlighted the difficult but crucial role that charity trustees and their senior management have in managing situations of financial distress. Some key messages are that:

- being prepared to address financial difficulties effectively is an important part of a trustee's duties to act in the charity's best interests, manage the charity's resources effectively, and ensure the charity is accountable - charities that are able to identify pressures and risks early are best placed to address them
- we expect trustees to take seriously any concerns expressed by their charity's auditor or independent examiner and take appropriate action in response
- we have provided guidance to help trustees identify and deal with situations of financial difficulty, in particular **planning for and managing financial difficulties**

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About our accounts monitoring reports

Charities' accounts are publicly available on our **online search tool**.

Each year, we monitor a sample to check compliance with the Charities Statement of Recommended Practice (SORP) and to identify issues of regulatory concern. We are publishing a series of reports on our findings to help trustees manage the risks that their charity faces, improve reporting standards and enhance the accountability of charities to their donors, beneficiaries and the public.

The scope and purpose of this review

This review looked at large charities in financial difficulty. For the purpose of this review, we have defined a large charity as one reporting an income of more than £1 million. All charities of this size require an audit[1].

Charity accounts are usually prepared on a 'going concern' basis of accounting, which assumes that the charity will continue its activities for the foreseeable future. The trustees have a duty to consider whether there are material uncertainties about their charity's ability to continue as a going concern. If this is the case, the SORPs that apply to accounting periods beginning on or after 1 January 2015 require the trustees of all charities to explain the nature of these uncertainties in the annual report. Where the accounts are prepared under the FRS 102 SORP, the trustees are also required to include in the notes a balanced, proportionate and clear disclosure of the uncertainties. If there are none, the SORP encourages this to be stated[2].

The auditors of charities also have a responsibility to consider whether there is a material uncertainty about the charity's ability to continue as a going concern and, if necessary, to draw the reader's attention to the situation in their audit report[3]. Audit reports are therefore a useful way of identifying large charities that are in financial difficulty.

1 For periods ending 31 March 2015 onwards, charities require an audit if their income is over £1 million (previously £0.5 million) or over £0.25 million and they have gross assets over £3.26 million.
2 Charities SORP (FRS 102): paragraphs 1.23 and 3.38 - 3.39. Charities SORP (FRSSE): paragraphs 1.24 and 3.40 (the accounts disclosure requirements are more limited).
3 International Standard on Auditing (UK) 570 (Revised June 2016): Going Concern.

How we carried out the review

We used a PDF text search to identify all the sets of accounts submitted to us in the 12 months ended 31 October 2015 that contained the phrase 'emphasis of matter'. At that time, auditors were required to include a paragraph headed 'emphasis of matter' in their audit reports when the going concern assumption was appropriate but a material uncertainty existed that was adequately disclosed in the accounts. We identified 335 sets of accounts that contained an emphasis of matter paragraph, of which 109 charities had an income of over £1 million. One hundred and one of the 109 emphasis of matter paragraphs were about going concern. We have excluded 7 of the 101 charities from the detailed analysis that follows because, although they were ceasing to operate, they were not in financial difficulty. In 5 of these cases the trustees were transferring the charity's activities to an incorporated charity or to its parent charity. Another was a grant making charity that intended to disburse its remaining funds and the final charity was closing because there were insufficient people to carry on its work.

The 94 charities included in our analysis had a combined income of £462 million. We reviewed each of the 94 sets of accounts to assess:

- the concerns about the charity's financial situation highlighted by the auditors
- the main reasons why the charity was in financial difficulty
- the actions that the trustees were taking in response

What we found

The concerns highlighted by auditors

Auditors are required to draw attention to the note in the accounts that discloses the matters that cast doubt on the charity's ability to continue as a going concern and the trustees' plans to deal with them. However, in 79 of the 94 emphasis of matter paragraphs the auditor also chose to highlight their main concerns about the charity's financial situation. Their concerns were of 2 types:

- current indicators of financial difficulty (37 charities)

  These paragraphs drew attention to indicators of financial difficulty based on the figures in the accounts. They usually referred to expenditure exceeding income in the year and/or the extent of net current liabilities. Negative funds and/or reserves were also highlighted in some audit reports, often in association with pension scheme deficits. We have used some of these indicators in our previous reviews of charity accounts and the reports are available on **GOV.UK**.

  It is worth noting that our reviews have shown that these indicators are useful signals of financial difficulty, but need to be interpreted in the context of the accounts as a whole. For example, the trustees may have planned to overspend in a particular year because of a large project for which they had set aside funds in previous years.

- matters affecting the charity's future financial situation (42 charities)

  These paragraphs had a more forward looking focus. The issues identified could be summarised into 4 types:

  1. Uncertainties over future funding (19 charities). The main examples were leisure and arts charities that relied on public sector grants or contracts, schools that depended on fee income and charities that needed to continue raising donations in order to maintain their activities at the level to which they were committed.
  2. Dependent on the continuing support of creditors (10 charities). Most of these charities relied on their bank continuing to provide sufficient overdraft and loan facilities, whilst others required the ongoing commitment of key supporters.
  3. Contingent liabilities (6 charities). These charities faced potentially material liabilities that could not be accurately estimated at the time the accounts were approved. They arose from HMRC investigations, contract termination, the valuation of a subsidiary and provisions for dilapidations and insurance claims.
  4. Winding up their activities (7 charities). Five of these charities had not prepared their accounts on a going concern basis. Another charity disclosed that its assets had been sold since the year end and the final charity was at an early stage in negotiations for the sale of its activities.

The reasons why charities were in financial difficulty

Not surprisingly, the ongoing challenging financial environment was the underlying factor behind many of the charities' difficulties. The specific reasons overlap to some extent with the issues highlighted by the auditors, although a wider range of factors emerged. These can be summarised as follows:

- the difficult economic climate (22 charities)

  Most of the charities that highlighted this general factor provided charged-for services and had suffered reductions in income. The main example was schools.

- dependence on public sector funding (22 charities)

  All of these charities received a significant part of their income from public sector grants or contracts and reported increased difficulties in obtaining funding and/or reductions in the amounts awarded. As previously noted, charities providing leisure and arts services were common examples.

- set up or restructure costs (13 charities)

  Some of these charities are recently established and had incurred significant set up costs. Others had restructured, taken on additional activities and/or made capital investments in order to make their activities more sustainable for the longer term.

- pension scheme deficits (12 charities)

  Nineteen charities reported a pension deficit in their accounts and for most of them this was seen as the main reason for their financial difficulties. Several of the charities in this position were also reliant on public sector funding.

- unplanned overspends (12 charities)

  Examples included capital projects and service contracts that had cost more than planned, donations falling below amounts expected and the costs of dealing with unexpected events, such as concerns highlighted by statutory inspections.

- future funding uncertain (7 charities)

  These charities were reliant on raising large amounts of voluntary income in order to continue their activities at the current level.

- contingent liabilities (6 charities)

  As noted in the discussion of concerns highlighted by auditors, these charities faced potentially material liabilities that could not be accurately estimated at the time the accounts were approved.

The action being taken by the trustees

As expected, the focus of the disclosures was usually on the reasons why the trustees believed that the charity had a reasonable prospect of being able to continue for at least another year and so could prepare the accounts on a going concern basis. The justification was normally based on a combination of assurances of continuing support from funders, supporters and/or bankers and financial and/or cash flow forecasts. However, all but 5 of the disclosures also included some information on the trustees' longer term plans for their charity's future. Their actions could be summarised as follows:

- dealing with a specific financial risk (28 charities)

  The trustees of these charities appear to have decided that the charity's activities were viable, provided that they could manage a specific financial risk effectively. In most instances, the actions reported focussed on how the trustees were dealing with this specific risk rather than on the viability of the charity's activities. The charities in this group comprise the 12 that highlighted a pension scheme deficit, 10 of those that were dependent on their main funders or supporters continuing to provide contracts or grants and the 6 that had contingent liabilities. Most of the charities with pension scheme deficits focussed on their ability to meet the annual payments recommended by the actuary, whilst those dependent on continuing financial support concentrated on their efforts to secure longer term commitments from key funders.

- improving the viability of the charity's activities (42 charities)

  The trustees of these charities appear to have concluded that its activities remained viable, provided that some changes were made to increase the income generated and/or reduce costs. For charities that provided charged-for services, such as schools and leisure facilities, the actions taken concentrated on increasing the numbers of people using their existing services. Other charities were looking to attract new sources of income and/or to increase fundraising. Some had invested in their facilities or staff as part of their plans to increase income. Fewer charities focussed on reductions in expenditure, with efficiency savings and staff reductions the main actions referred to. The sale of land and/or property to reduce liabilities was another course of action planned, although it was not always made clear that the assets being disposed of were surplus to the delivery of the charity's activities.

- restructuring of the charity's activities (10 charities)

  The trustees of these charities appear to have decided that its activities were not viable as currently provided and that major changes were needed. Whilst most charities in this position were reducing the scale of their activities, including 2 providers of leisure services that had lost their main contracts, 2 saw increasing the scale of their operations as the means of survival.

- the charity's activities are no longer viable (9 charities)

  The trustees of these charities had reached the point where they believed that its activities were no longer viable and that the charity may need to wind up. Seven of these charities are those highlighted by auditors as winding up their activities. The other 2 charities are a parent and its subsidiary, where the trustees are considering options for the future of both charities.

What action we took

Reviewing up to date information on each charity's financial position

We checked our records for more up to date information on each charity's financial position, in particular whether it had ceased to operate or filed more recent accounts. Our findings can be summarised as follows:

- ceased to operate (9 charities)

  Trustees must tell us if their registered charity ceases to exist or operate. Two of the charities that our records show have ceased to operate were amongst the 9 where the trustees were winding up their charity's activities or considering doing so. However, the trustees of the other 7 charities had appeared to be taking action to put their activities on a more sustainable basis. Five of these 7 charities were reliant on public sector funding and 3 of them also had pension scheme deficits. Another charity had been looking to diversify its income sources following the end of a grant from a key funder. The final charity was a school.

- filed a more recent set of accounts and/or annual return (62 charities)

  Fifty-seven of the charities have submitted more recent audited accounts. The incomes of 3 of the other 5 charities that have filed have fallen below the audit threshold. However, the remaining 2 charities should have filed audited accounts. One has filed its annual return, but the accounts are several months overdue. The other charity filed accounts, but with an accountant's report rather than the required auditor's report. We have contacted the trustees of both charities in respect of these deficiencies.

  We have reviewed the 57 sets of more recently submitted audited accounts to identify whether there are still material uncertainties regarding the charity's ability to continue as a going concern. We found that they fell into 3 groups:

  1. Confirmation that there are no material uncertainties regarding the charity's ability to continue as a going concern and no emphasis of matter paragraph included in the audit report (25% of charities (14)). All of these charities reported a surplus in their following year's accounts. The trustees of these charities look to have put their charity's finances on a firmer footing.

2. Continuing material uncertainties regarding the charity's ability to continue as a going concern and an emphasis of matter paragraph included (66% of charities (38)). Fifteen of these charities appear to have made progress in financial recovery, 10 look to be in a similar position and 13 seem to be in more difficulty than a year earlier.
3. The charity is no longer a going concern (9% of charities (5)). The accounts of 3 of these charities had not been prepared on a going concern basis because they were being wound up. 2 of the 3 charities were already in this position in the previous year. The accounts of the other 2 charities had been prepared on a going concern basis, but their auditors had issued adverse audit opinions, stating that the charity's use of the going concern basis was no longer appropriate. These charities are now in a precarious financial position and we have already contacted the trustees of these 2 charities to raise our concerns and find out what action they are taking.

- no more recent information held (23 charities)

  Most of the charities in this group are not yet due to have submitted their next year's accounts, although 2 are several months overdue. One of these charities is the subject of a statutory inquiry. We have contacted the trustees of the other charity that is late in filing.

Visits to charities

In addition to our desk-based scrutiny and review, our monitoring team has carried out a complementary programme of proactive inspection visits to charities with signs they are in financial distress. The aim of the visits was to gain assurance that the trustees had put in place appropriate and adequate measures and controls to comply with their duties of financial management. Five of the charities identified by this review were included in the programme of inspection visits. The results are published on **GOV.UK**.

Provision of regulatory guidance

It is for the trustees to manage their charity effectively and so the commission cannot become involved in the internal administration of a charity, including restructuring and refinancing. However, we do have a regulatory role if we find evidence of mismanagement, maladministration or risk to property held for charitable purposes. We have produced updated regulatory guidance to help the trustees of charities which are facing financial difficulty ('**Managing a charity's finances: planning, managing difficulties and insolvency (CC12)**'). We have contacted the 69 charities in our review that are continuing to operate and with which we are not currently engaged to remind them of their duties and responsibilities and provide them with guidance, including a link to updated CC12.

Updating the reporting responsibilities of auditors and independent examiners

The UK charity regulators are consulting on extending the matters of material significance that must be reported by auditors and independent examiners to the regulator to include those concerns that the auditor or examiner identifies in his or her work. These concerns include when the auditor modifies his or her audit opinion or identifies a concern, whether by an emphasis of matter or material uncertainty, over going concern. Concerns identified in an independent examiner's report are also included. This will enable prompt notification to the regulator of these concerns for our review.

Lessons for other charities

Our review has highlighted the challenges that the difficult financial environment presents for charities and some of their strategies for dealing with them. Whilst the appropriate response will vary according to the charity's circumstances, charities should remember that reviews of the efficiency and effectiveness of their operations and services are as important as planning to expand activities, which has its own risks, and seeking additional funding. Collaborating or merging with another charity, or even winding the charity up, are also options that charities should be ready to use.

Our review has also highlighted the difficult but crucial role that charity trustees and their senior management have in managing situations of financial distress. The charities in our review included several examples of both financial recovery and orderly closure. However, this was not the experience of most of the charities. Three quarters of those charities that have submitted more recent audited accounts remain in financial difficulty and 7 other charities that had expected to be able to continue ceased to operate before submitting another set of accounts. Our findings indicate that charities reliant on public sector funding and/or fixed term contracts or grants may be particularly vulnerable.

In this context, our key messages are that:

- being prepared to address financial difficulties effectively is an important part of a trustee's duties to act in the charity's best interests, manage the charity's resources effectively, and ensure the charity is accountable - charities that are able to identify pressures and risks early are best placed to address them
- we expect trustees to take seriously any concerns expressed by their charity's auditor or independent examiner and take appropriate action in response; auditors should consider reporting their concerns directly to the commission
- we have provided guidance to help trustees identify and deal with situations of financial difficulty, in particular **15 questions trustees should ask** and **planning for and managing financial difficulties**