

CHARITY AUDIT AND INDEPENDENT EXAMINATION

Cabinet Office Consultation – December 2014

Submission by Professor Gareth G Morgan

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1. About myself

I am Professor of Charity Studies and Leader of the Centre for Voluntary Sector Research at Sheffield Hallam University.

I am also course leader for the University's MSc in Charity Resource Management which can enable students to achieve the ICAEW Diploma in Charity Accounting and/or the ACIE Charity Accounting Certificate.

Over the last 20 years I have led a wide range of research – in some cases with colleagues from other universities – on issues of charity regulation and accounting. In particular, I am the author of a number of research papers specifically on the independent examination regimes in the UK, which have been presented at academic conferences and published in refereed journals¹

For part of the week when I am not engaged on my University duties, I also act as professional adviser to a number of charities through The Kubernesis Partnership LLP, including a small number for whom I act as independent examiner (IE). I also provide a second level help and advice service to other charity accountants and IEs.

I was also active from 1999-2004 in helping to establish the Association of Charity Independent Examiners (ACIE) – but for the last 10 years I have had no formal role in ACIE

¹ Morgan, GG. A Statutory Regime for "Lay Audits": Assessing the First Five Years of Charity Independent Examiners (British Accounting Association Conference, Manchester, April 2003)

Morgan, GG. *Changing the Charity Audit Threshold: Implications for Auditors and Independent Examiners* (Institute of Chartered Accountants in England & Wales - Charity & Voluntary Sector Group News, 14, April 2004, 1-2).

Morgan, GG. *Statutory Self-Regulation in the Third Sector: The Case of Charity Independent Examiners* (International Society for Third Sector Research, Toronto, Canada, July 2004).

Morgan, GG. *Auditing Financial Statements without a True and Fair Opinion: Assessing the Effectiveness of Charity Independent Examiners* (British Accounting Association - Auditing Special Interest Group - 15th National Auditing Conference - Aston University March 2005.)

Morgan, GG. *Charities and Self-Regulation: Theory and Practice in the Role of Independent Examiners under s43(3) of the Charities Act 1993* (Charity Law and Practice Review, 8(3) 2005, 31-54).

Morgan, GG. *Scrutiny, Examination, Review or Audit: Alternative Models of Reporting on the Accounts of Smaller Charities* (British Accounting Association Annual Conference, University of Portsmouth, April 2006).

Morgan, GG. *The Role of Independent Examiners in the Accountability of UK Charities* (Public Money & Management 31(3), 183-192, 2011).

except as an individual Fellow of ACIE and as an occasional contributor to ACIE publications and activities.

I am not an auditor, but I am a professionally qualified IE (able to act for charities in England and Wales between £250K and £500K income) as a result of two qualifications which fall within s.145(3)&(4) of the Charities Act 2011. Some of the charities for whom I have acted as IE over the last 10 years have relatively complex accounts whilst falling within the IE band.

2. General Comments on the Issues in the Consultation

Audit Threshold

- 2.1 I very much welcome the Government's decision to consult on raising the charity audit threshold as recommend by Lord Hodgson's review of the 2006 Act. An increase clearly makes good sense for the reasons set out in more detail in answer to Q1 below.

Asset Test

- 2.2 However, I feel a huge opportunity will be missed if the Government retains the additional requirement for a charity to be forced to have an audit if it has significant assets even when its income is below the normal audit threshold, *but only if it has more than a certain level of income*.
- 2.3 I consider that this requirement – in s.144(1)(b) of the Charities Act 2011 – serves no effective regulatory purpose. It is a source of immense confusion when attempting to provide training or guidance to charities on the various accounting thresholds.² I have even known accountants in membership of CCAB bodies who have overlooked this requirement. Almost all other thresholds in charity law relate to measures of charity income.
- 2.4 If the Government is concerned to force the more rigorous scrutiny of audit on to charities with significant assets but modest incomes, why have the 'accounts threshold' in s.144(1) at all? Why not require every charity, no matter what its income, to have an audit if it has more than the specified level of assets? The answer is that this would impose a huge burden on a small number of charities with low income but valuable buildings, and in response to representations when the legislation was originally under consideration, an exemption from the asset test was included for those within the income band where receipts and payments accounts are permitted. But I can see no rationale for this.
- 2.5 It is worth nothing the illogical status of the current accounts scrutiny requirements which apply to a charity in England or Wales with over £3.26M assets:
- If its income is not over £25K, then *no external scrutiny is required at all* – even though it has over £3M assets!
 - If its income is between £25K and £250K it will be sufficient to have a *lay independent examination*.

² See, for example, table 2.1 *Minimum accounting requirements for charities subject to the law of England and Wales* in my book *The Charity Treasurer's Handbook* (4th edn, Directory of Social Change 2014). As a result of the assets test in s.144(1)(b) this table – which is aimed at non-specialist charity treasurers – requires a whole additional column to distinguish 'charities with not more than £3.26 million assets' and 'charity has over £3.26 million assets'.

- If its income is over £250K it requires a full audit.

The one kind of scrutiny which *does not appear* in this list is the *professional independent examination* (under s.145(3)) – this would be entirely appropriate for a charity with over £3M assets but modest income. Rather, the rules jump straight from the lay independent examination to the full audit.

- 2.6 It was for this reasons that Lord Hodgson’s Review of the 2006 Act recommended that the ‘asset test’ should be removed – in the paragraph quoted on page 7 of the consultation document. I understand he had received strong representations that this requirement was unhelpful, not least in the submission he received from the ICAEW.
- 2.7 It is also worth noting that this asset-related audit requirement does *not* appear in the Charities Act (Northern Ireland) 2008 even though in almost all other respects the Northern Irish legislation follows the English legislation following the changes made by the Charities Act 2008. The charity sector in Northern Ireland could see the difficulties of this.
- 2.8 The parallels with company law as mentioned on page 7 of the consultation document are not really relevant because there is no ‘accounts threshold’ in the balance sheet test in s.477(2) of the Companies Act 2006. The current situation in company law is that any company over £3.26M assets must have an audit.
- 2.9 However, in response to the consultation by BIS on audit and accounting thresholds in company law attention has been drawn to the differences between the audit exemption criteria in company law which is slightly different from the normal ‘small company’ definition in ss.381-384 of the Companies Act 2006. Under the latter provisions, a company is only classed as medium or large if *it exceeds two out of three* of the relevant thresholds (turnover, assets, employees) – so a company can still fall within the small company accounting regime, *even if it has over £3.26M assets*, if its turnover is not over £6.5M and if it has not more than 50 employees.
- 2.10 But for charities, even with the increase in the audit threshold now proposed, an audit will be triggered in any case if the income is over £1M (rather than £6.5M or more if BIS proposals are implemented). So even with no asset test *the charity audit requirement will still be much tighter than the company audit requirement.*

The Independent Examination Regime

- 2.11 My research has found that the independent examination regime is for the most part robust and effective. It is governed by three levels of regulation:
- by primary legislation - in the 2011 Act;
 - by secondary legislation - in the Charities (Accounts and Reports) Regulations 2008 – which gives IEs a statutory right of access to information and explanations and which specify in considerable detail the reporting obligations of IEs
 - by the Directions of the Charity Commission under s.145(5)(b) of the 2011 Act (currently in publication CC32).

- 2.12 An independent examination is only validly undertaken when the IE has *carried out all ten Directions of the Commission*³ and has considered the *seven separate reporting obligations*⁴ in the Regulations – any one of which could trigger a qualified report.
- 2.13 Moreover, both IEs are subject to *identical* whistleblowing duties under s.156 of the 2011 Act. They also have the *same rights to information and explanations* under reg.33 of the 2008 Regulations.
- 2.14 The IE regime is further strengthened by the requirement for a professionally-qualified IE s.145(3)-(4) when the charity's income exceeds £250K.
- 2.15 It is worth noting that the present consultation is *only* concerned with extending this regime for professionally-qualified independent examinations. In my experience, most of the concerns about poor independent examinations relate to lay independent examiners (as permitted for charities not over £250K income). *I consider the Government is right in deciding not to extend the lay IE regime.*

Strengthening the IE Regime

- 2.16 Whilst I believe the IE regime is generally working well I believe it could be strengthened in two ways.
- 2.17 Firstly, more education is needed about independent examination – particularly amongst those who act as IEs on an occasional or casual basis (including accountants who are not charity specialists) to make clear that: *unless the IE has followed the Commission's Directions in CC32 and considered all his/her reporting obligations under the 2008 Regulations, the charity's accounts have not actually been examined as the law requires.*

This could be achieved – for example – by reminders to registered charities in CC News, by similar outreach to excepted charities, and by work with professional bodies to encourage them to highlight more clearly to their members the duties of IE (particularly those who only undertake charity work occasionally). It is worth stressing in such communications that the headline *directions* in CC32 are not just *guidance* from the Commission. Each direction begins “The Examiner shall...” – they are *mandatory requirements* under the 2011 Act. Whilst experienced IEs are very familiar with the Directions, I do not believe this is widely understood by others, notwithstanding the requirement to mention compliance with the directions in the wording of IE reports.

However these suggestions relate mainly to lay IEs – I do not believe there are major concerns regarding professional IEs which is the issue in the present consultation.

³ Certain Directions can be omitted for receipts and payments accounts, but the proposals in the current consultation will only apply where the accounts are on the accruals basis.

⁴ Charities (Accounts and Reports) Regulations 2008 – regs 31(i)&(j). The seven criteria which the IE must explicitly consider for a possible qualified report on the charity's accounts may be paraphrased as:

- (i) inadequate accounting records
- (ii) accounts not in accord with the records
- (iii) accounts failing to comply with the regulations/SORP where applicable
- (iv) other matters than need to be disclosed for a proper understanding
- (v) material expenditure or action outside the trusts of the charity
- (vi) lack of information or explanations from trustees, officers or employees
- (vi) inconsistency between the accounts and the trustees' annual report.

2.18 Secondly, I believe it is time for a review of the Commission's statutory directions under s.145(5)(b). Whilst they are generally sound, it is possible for someone running a charity fraudulently to keep accounting records which appear to be in good order, and to produce accounts which comply with those records, where the records are actually misleading or falsified – but unless the IE senses something is awry, the accounts could still receive a clean IE report. At present an IE is only required to undertake substantive verification of entries in the records where concerns arise from an analytical review (Direction 6), but I suggest it would be helpful to require some verification (on a sampling basis) in all cases – or certainly for charities over £250K where a professional IE is required.

3. Responses to the Specific Consultation Questions

Question 1. Do you agree that the income threshold at which charities should have to have their accounts audited should be increased from £500,000 to £1 million?

3.1 Yes, this makes very good sense. As explained above, this will only result in an extension to the regime where the IE is professionally qualified.

3.2 As reported in the research mentioned⁵, the IE regime is fundamentally very robust – it covers much more than other forms of limited assurance such as the reporting accountant regime which used to apply to smaller charitable companies. And at the level of the professionally-qualified IE, I am not aware of any significant concerns regarding the operation of the IE regime.

3.3 An audit is a considerable extra expense which diverts charitable funds from direct expenditure on beneficiaries. I have estimated that the increase in the audit threshold from £250K to £500K in 2007 and the extension of IE to charitable companies from 2008 has potentially released around £27M of charitable funds in five years 2008-13. Whilst the number of charities between £500K and £1M is somewhat smaller, the benefits will still run to many millions of pounds (see also my further comments below under Question 6).

3.4 It will of course remain possible for individual charities in the £500K to £1M band to have an audit if they feel it necessary, and for funders to require audits. It is also worth stressing the Commission's power in s.146 of the 2011 Act to order an audit where it considers this necessary. This is a useful power in the Commission's armoury which can be exercised without the need to open a statutory enquiry.

Question 2. Do you agree that the aggregate group income threshold at which parent charities should have to have group accounts audited should be increased from £500,000 to £1 million?

3.5 Yes, this threshold should definitely be aligned to the audit threshold.

Question 3. Do you agree that the income component of the asset threshold should be increased from £250,000 to £500,000?

3.6 No. For the reasons explained above (see paras 2.2 to 2.9) *the entire asset test should be removed*. It has little or no regulatory value and is simply a source of confusion. To do so would be a very helpful deregulatory measure.

⁵ See footnote 1.

- 3.7 As noted above, even without the mandatory asset test, the Commission could still order an audit under s.146 in the case of a charity where the high level of assets led to regulatory concerns.
- 3.8 If however, the Government is of the view that charities with significant assets should be required to have an audit even though their income is modest, this threshold should be *reduced* (preferably to zero) – *not* increased. But this would have a compliance cost for the small number of charities affected.
- 3.9 But as explained above, I consider it is simply absurd to have an asset test which is only triggered for charities in that fall in a limited income band.

Question 4. Do you think that the asset component of the asset threshold should stay at £3.26 million in line with company law (Option 1) or increase to £5 million (Option 2)?

- 3.10 If an asset test is to remain the threshold should be aligned with the final figure under company law following the BIS review as the consultation proposes.

Question 5. Do you envisage any difficulties arising from these proposed changes to the threshold? If so, please provide evidence to support your view.

- 3.11 I do not envisage any difficulties from increasing the audit threshold.

Question 6. Do you agree with the estimated costs and cost savings outlined in Part IV? It will be helpful if you can provide actual examples of the difference in the costs between the two forms of examination.

- 3.12 I would broadly endorse the figures in Part IV of the consultation document. Opting for a professional independent examination rather than audit leads to three or four distinct factors each of which can lead to a reduced fee. Cumulatively the savings may be considerable.⁶

⁶ The following factors may *each* lead to savings in the fee by opting for IE rather than audit:

(a) Even with a firm of accountants which is also a registered auditor, an IE fee will often considerably be cheaper than an audit fee for the same charity because the additional time to comply with international standards in auditing (ISAs), documentation for audit monitoring etc is saved. Also, in a large firm, the work can be undertaken by qualified staff below partner level.

(b) There are now a number of medium size accountancy practices which specialise in charities, often offering excellent services, but which do not hold an audit registration. In general their fees are likely to be lower than the audit firms – so the use of such non-audit firms offers a further saving. (With most non-charitable businesses only requiring an audit if their turnover exceeds £6.5M, many smaller firms have given up their audit registration.)

(c) The option of professional IE rather than audit also gives access to examiners who, whilst professionally qualified, are not based in firms of accountants. This includes, for example, staff of community accountancy projects (charities which provide accountancy services to other voluntary organisations, often on a subsidised basis). There is also a good range of individuals from other professional backgrounds offering IE services either as sole practitioners or in small firms. Typically they have studied charity accounting and hold qualifications with one of the bodies listed in s.145(3)&(4) of the 2011 Act – e.g. Fellows of ACIE or Chartered Secretaries (ICSA) or Fellows of AAT. Others may hold chartered qualifications though CIMA or CIPFA. Whilst such IEs will almost always be charging fees of some kind, they generally have much lower overheads than accountancy firms, or may be prepared to work at lower hourly rates.

(d) A number of the firms and individuals in categories (b) and (c) have a turnover below the VAT threshold, but this is very rare for audit firms. Most charities are unable to recover VAT so the VAT element of an audit fee is a substantial part of the cost. In those cases where the decision to use an IE rather than an auditor enables the services to be provided by an IE who is not VAT registered, the VAT saving can be considerable (e.g. £500 on a £2500 ex-VAT fee).

- 3.13 If the option of a professional independent examination is extended to charities between £500K and £1M income, I think your estimates of around £2,500 as a typical IE fee and £4,750 as a typical audit fee are about right.
- 3.14 However, I think the estimated familiarisation costs in Part IV of the consultation document seem very high. Although there will be a cost to those who issue training materials and guidance on charity accounting it is hard to see any cost for individual charities as they will simply be offered the *option* of IE rather than audit. The change will only affect charities between £500K and £1M income, and in my experience the vast majority of such charities already have a treasurer or finance officer with some appreciation of the differences between IE and audit. However, the point about search costs is valid. But I agree these will be far outweighed by the savings.

Question 7. Do you have any other comments about the proposed change to the threshold?

- 3.15 No further comments.

Question 8. Do you agree that the preparation threshold for group accounts should be consequentially increased in line with the audit threshold from £500,000 to £1 million?

- 3.15 Yes, I agree with this proposal. It would be onerous to have a group accounts preparation threshold below the audit threshold. It would also mean the Commission would have to issue directions on the independent examination of group accounts under s.152 of the 2011 Act, which it has declined to do as the IE of group accounts is never mandatory at present.
- 3.16 Currently some charities with relatively modest income can be caught by this requirement (e.g. a charity with £150K income that controls a trading subsidiary with £400K turnover). The requirement to prepare group accounts and also to have an audit is a considerable extra cost for a charity which could otherwise have prepared receipts and payments accounts (if not a company) and used a lay IE. So an increase in this threshold would be very welcome (for the small number of charities affected).

Question 9. Is there a recognised professional accountancy membership body that you propose could be added to the list of those whose appropriately qualified members can carry out independent examinations of the accounts of charities with incomes that are more than £250,000?

- 3.17 I am not aware of any particular body, but I would not object in principle to adding another body to this list if it meets the requirements mentioned in the consultation document.

- 3.18 However, I would stress that the following issues should be considered:

- (a) If the body is a general-purpose accountancy body which does not require its members to have a charity-specific qualification, any addition of that body to the lists in s.145 should be conditional on the body putting in place appropriate arrangements so that members who are then authorised to act as professional IEs only do so after appropriate training or study of charity accounting requirements and the duties of IEs in particular.

- (b) Careful consideration is needed as to whether any new body should be added to s.145(3) – with reference to a particular grade of membership (as with ACIE) or whether it should be added to s.145(4) where the body as a whole is listed and permitted to make its own regulations. At present the approach is rather inconsistent – for example I understand AAT only allows Fellow members to act as professional IEs so it would have been more logical to include Fellows of AAT in s.145(3). If it would only be appropriate to allow the most senior members of the new body to act as professional IEs, it would be clearer to specify this explicitly by including them in s.145(3). Alternatively, perhaps ACIE should be moved from the s.145(3) list to the s.145(4) list and allowed, like other professional bodies, to make its own regulations on which members may act as professional IEs (which I understand it already does through its criteria for Associate Members and Fellows).

Question 10. If you have suggested a body to be added to the list of those whose members should be able to act as independent examiners, please provide a detailed explanation of how they meet the criteria outlined in this document.

3.19 No comment.

Gareth G Morgan
19 January 2015