CHARITY AUDIT AND INDEPENDENT EXAMINATION

CONSULTATION ON:

- **RAISING THE FINANCIAL THRESHOLDS AT WHICH CHARITIES' ANNUAL ACCOUNTS MUST BE AUDITED**
- **CONSEQUENTIALLY RAISING THE THRESHOLD AT WHICH CHARITY GROUP ACCOUNTS MUST BE PREPARED**
- **EXTENDING THE LIST OF PROFESSIONAL ACCOUNTANCY MEMBERSHIP BODIES ABLE TO CARRY OUT EXAMINATIONS OF THE ACCOUNTS OF CHARITIES WITH AN INCOME OF MORE THAN £250,000.**

DECEMBER 2014

CONTENTS

Part I - About this consultation

Topics of this consultation

Accurate, clear and publicly available information about charities' finances and activities is essential to ensure public confidence in both individual charities and the charity sector as a whole. Charity law requires charities to be transparent and accountable but it is important that that the regulatory requirements are proportionate. It is also important that, where it is a legal requirement, the independent external scrutiny of charities' accounts is carried out by people who are suitably qualified to carry out an examination in a way that is proportionate to the size of the charity.

The requirements for the independent scrutiny of charity accounts become increasingly demanding the larger a charity is until there is a requirement for annual accounts to be audited by an auditor whose name appears on the Register of Statutory Auditors, if a charity has:

- an annual income from all sources (income) of more than £500,000 ("the income threshold"); or
- assets worth more than £3.26 million and an income of more than £250,000 (together, "the asset threshold").

Charities with an income below those thresholds can have their accounts audited, either because their governing document requires it, or voluntarily at the instigation of trustees, or in some cases funders.

In his report on the operation of the Charities Act 2006 (the 2006 Act), *Trusted and Independent: Giving charity back to charities (Trusted and Independent)*, Lord Hodgson of Astley Abbotts recommended that charities should only have their accounts compulsorily audited if their income is more than £1 million, with no asset threshold.

In its response to Lord Hodgson, the Government partially accepted this recommendation and agreed, subject to consultation, to increase the income threshold but to retain an increased asset threshold. However, we are aware that the £3.26 million component of the asset threshold is shared by companies under company law and are wary of creating a discrepancy. This does not affect the increase of the income component of the asset threshold at which it is triggered.

Consequently this consultation is about increasing the thresholds so that a charity is required to have its accounts audited, or a parent charity has to have its group accounts audited, where it has:

- an income of more than £1 million; or
- one of either:
    - assets worth more than £3.26 million and an income of more than £500,000
    - assets worth more than £5 million and an income of more than £500,000.

In the case of charities that have subsidiaries (charity group), group accounts would have to be audited if the aggregate group income exceeded £1 million. The asset threshold does not apply to group accounts.

Consequentially, we are proposing to increase the threshold above which parent charities must prepare group accounts from a total income of £500,000 to £1 million. This would ensure no discrepancy between the threshold above which a parent charity must prepare group accounts and the threshold above which that same charity would have to have those group accounts audited.

We would also like to find out whether there are any additional professional accountancy membership bodies that can be added to the list of those whose appropriately qualified members can carry out independent examinations of the accounts of charities with an income that is more than £250,000.

A complete list of questions asked in this consultation can be found in Part III.

Scope

This consultation applies to the law of England and Wales, as charity law is devolved in Northern Ireland and Scotland.

The audit threshold changes that we are consulting about potentially affect all charities (and charity groups) in England and Wales that have an income between £500,000 and £1 million or have an income between £250,000 and £500,000 and assets valued at more than £3.26 million and are directly regulated by the Charity Commission (the Commission).

The requirement to have accounts independently examined by an appropriately qualified member of a professional accountancy membership body listed in section 145 (section 145) of the Charities Act 2011 (the 2011 Act) applies to (registered and excepted) charities that have an income of over £250,000 and are not required either by law or their governing document to have their accounts audited.

Neither of the requirements apply to “exempt” charities, that is to say charities that are not subject to the Commission’s direct regulation. Most exempt charities are listed in Schedule 3 to the 2011 Act and include major museums and galleries, such as the British Museum and National Gallery, most universities in England, sixth form and further education colleges and foundation, voluntary and academy schools.

Audience

Anyone may respond to this consultation and all responses will be fully considered. The Cabinet Office will be particularly interested to hear from charities that would be affected by these changes, charity sector umbrella bodies, organisations that fund charities, charities’ professional advisers, accountants, auditors, professional accountancy bodies as well as members of the public who have an interest in charity accounts and the scrutiny of them, such as donors and volunteers.

Body responsible for the consultation

Cabinet Office Ministers are responsible for the legal and regulatory framework for charities in England and Wales and the Cabinet Office is responsible for this consultation.

Duration

The Government wishes to consult over 7 weeks from 9 December 2014 to 27 January 2015. The deadline for responses is 5.00pm, 27 January 2015.

How to respond or make an enquiry

There are two ways to respond to the consultation:

Email:

Submit your response or enquiry via email to charities-act@cabinetoffice.gov.uk

Postal:

Send a written response to

Charity audit and independent examination consultation
Office for Civil Society
Cabinet Office
4th Floor
1 Horse Guards Road
London, SW1A 2HQ.

If you have any questions about the consultation, please e-mail them to charities-act@cabinetoffice.gov.uk

When they respond, representative groups are asked to give a summary of the people and organisations they represent, and where relevant, who else they have consulted in reaching their conclusions.

Responses to this consultation will be shared with the Charity Commission and may be shared with other Government departments. Responses may be published in full or in a summary of responses.

All information in responses, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004). If you want your response to remain confidential, you should explain why confidentiality is necessary and your request will be acceded to only if it is appropriate in the circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the department.

After the consultation

We will acknowledge receipt of all responses, and all responses will be considered. The aim is for a summary of the consultation responses to be published early in 2015 together with the Government's response. The aim would be for changes to come into force on 6 April 2015:

- the financial thresholds above which an audit of the accounts of larger charities is required can be varied by a statutory instrument under section 174 of the 2011 Act;
- the financial threshold above which the preparation of group accounts is required can be varied by a statutory instrument under section 139 of the 2011 Act;
- the financial thresholds above which an audit of group accounts is required can be varied by a statutory instrument under section 176 of the 2011 Act; and
- the list of organisations whose members can carry out independent examinations can be amended by a statutory instrument under section 145 of the 2011 Act.

Part II - Background

What are we consulting about?

Audit thresholds

All charities, whether or not they are registered with the Commission, must prepare annual accounts, which are public documents that any member of the public may ask to see. This is an important element in ensuring that charities are transparent and consequently, maintaining public confidence in them.

The requirements for the independent scrutiny of charity accounts become increasingly rigorous the larger a charity is. Section 145 of the 2011 Act requires that all charities with an income of more than £25,000 must have their accounts externally examined by an independent examiner (if they do not to have an audit). An independent examiner is an independent person who is reasonably believed by the charity's trustees to have the requisite ability and practical experience to carry out a competent examination of the accounts. If a charity has an income of more than £250,000 the independent examination must be carried out by an appropriately qualified member of a professional membership accounting body listed in section 145 of the 2011 Act. Charities that have:

- an income of more than £500,000; or
- assets worth more than £3.26 million and an income of more than £250,000;

must have their annual accounts audited by an auditor, whose name appears on the Register of Statutory Auditors.

We want to seek views about increasing the thresholds so that a charity is required to have its accounts audited when it has:

- an income of more than £1 million; or
- one of either:
    - assets worth more than £3.26 million and an income of more than £500,000;
    - assets worth more than £5 million and an income of above £500,000.

Group accounts

In addition, charities that have either charitable or non-charitable subsidiaries (charity group) must prepare group accounts where the income of the group, after eliminating internal group transactions and consolidation adjustments, exceeds £500,000 and must also have their group accounts audited. Increasing the above thresholds would mean that group accounts would have to be audited if the aggregate group income exceeded £1 million. The asset threshold does not apply to group accounts.

Rather than requiring charities to prepare group accounts where total group income exceeds £500,000 and have those same accounts audited only where the total income exceeds £1 million, we are also proposing to increase the group accounts preparation threshold from £500,000 to £1 million. A discrepancy between these two thresholds would mean that group accounts prepared by a parent charity whose total group income is between £500,000 and £1 million would only be subject to independent examination. We consider that independent examination is not well-suited to the scrutiny of group accounts.

Professional accountancy membership bodies

We also want to know whether there are any professional accountancy membership bodies that can 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. Such a change will increase the choice of professionally qualified independent examiners available to those charities and may make it easier for them to find a suitable examiner.

A complete list of questions asked in this consultation can be found in Part III.

Why are we consulting?

The Government is committed to making it easier to run a charity, social enterprise or voluntary organisation.

Accurate, clear and publicly available information about charities' finances and activities is essential to ensure public confidence in both individual charities and the charity sector as a whole. Charity law requires charities to be transparent and accountable but it is important that that the regulatory requirements remain proportionate.

In *Trusted and Independent* Lord Hodgson recommended that charities should only have to have their accounts audited, if their income is more than £1 million, with no asset threshold. He argued:

> *A full audit is an expensive and time-consuming exercise and, although it is right that large organisations should submit to this level of scrutiny in the interests of good regulation and management, the current threshold of £500,000 income per year seems a low level at which to impose this requirement. A level of £1 million draws a better balance. On similar lines, the existing 'asset test' that requires organisations with assets worth £3,260,000 to undergo an audit was criticised by some as unnecessary and hard to apply in practice. This is an additional element of complexity that should be removed.*

In its response to Lord Hodgson, the Government partially accepted this recommendation agreeing, subject to consultation, to increase the income threshold but to retain an increased asset threshold, because it continues to believe that charities that have significant assets should be subject to a full audit even when their income is relatively low.

However, the Government is aware that the asset threshold above which companies must usually have their annual accounts audited also currently stands at £3.26 million. Specifically, company law currently requires limited companies to have their annual accounts audited if they meet two out of the following three criteria:

- assets worth more than £3.26 million;
- gross income over £6.5 million;
- more than 50 employees.

The Department for Business, Innovation & Skills has consulted on implementation of the Accounting Directive, but has proposed to retain the audit exemption thresholds for the small undertakings as part of the initial implementation. Even allowing for the fact that charities are dependent on public confidence and should be accountable to the public, the disparity between the charity and company law requirements is significant. We take the view that it would be desirable to maintain consistency between the charity asset threshold and the company law asset threshold, and so whilst seeking views on increasing the asset component of the charity asset threshold from £3.26 million to £5 million, our preference is to retain it at the same level as the company asset threshold. This is separate to the income component of the asset threshold, which we propose to increase.

In addition we have received an approach from a recognised professional accountancy membership body asking if it can be added to the list of those whose appropriately qualified members can carry out independent examinations of the accounts of charities with an income of more than £250,000. Consequently we would like to know if there are any other organisations whose members might also act in that capacity, so increasing the choice of appropriately qualified persons available to charities that must have their accounts independently examined by an accountancy professional.

Part III – Proposals for consultation

Proposed Changes

Raising the audit financial thresholds

We are proposing to increase the financial thresholds so that a charity is required to have its accounts audited where it has:

- an income of more than £1 million; or
- one of the following two options:
    - OPTION 1
      assets worth more than £3.26 million and an income of above £500,000.
    - OPTION 2
      assets worth more than £5 million and an income of above £500,000.

Our preferred option is OPTION 1, as this would achieve a deregulatory saving for charities whilst keeping the asset value of the asset threshold in line with that for companies.

We estimate that this will give around 3,800 to 4,000 registered charities the option of qualified independent examination of their accounts rather than full audit, depending on the option chosen. They will still have to have their accounts externally examined by an independent examiner who has a professional accounting qualification, which is normally cheaper than an audit but still provides the assurance that the accounts have been subject to proportionate external scrutiny. A further safeguard is that all registered charities with an income of more than £25,000 must send their accounts and annual report to the Commission within 10 months from the end of their financial year, which the Commission then publishes on its website. This makes financial information about larger registered charities very accessible to the public, as well as charity donors and funders.

The trustees of charities that will no longer be legally required to have their accounts audited will still be able to choose to continue have an audit if they believe that it will be in the charity's interests to do so. A charity's governing document can also mandate the auditing of a charity's accounts irrespective of its income. If the Commission has a concern about a charity's finances it can require an audit to be carried out under section 146 of the 2011 Act and can also order an audit of group accounts under section 153 of that Act.

What is an independent examiner?

An independent examiner is described in section 145 of the 2011 Act as "*an independent person who is reasonably believed by the charity trustees to have the requisite ability and practical experience to carry out a competent examination of the [charity's] accounts*". When a charity's income exceeds £250,000, the examiner must be a person who is a member of one of the following organisations listed in section 145 of the 2011 Act and allowed by the rules of that organisation to undertake the role of independent examiner:

- Institute of Chartered Accountants in England and Wales.
- Institute of Chartered Accountants of Scotland.
- Institute of Chartered Accountants in Ireland.
- Association of Chartered Certified Accountants.
- Association of Authorised Public Accountants.
- Association of Accounting Technicians.
- Association of International Accountants.
- Chartered Institute of Management Accountants.
- Institute of Chartered Secretaries and Administrators.

- Chartered Institute of Public Finance and Accountancy.
- a Fellow of the Association of Charity Independent Examiners.

What is an independent examination?

Independent examination is a simpler and less detailed form of accounts scrutiny than audit that still provides trustees, donors, funders, beneficiaries, other stakeholders and the public with assurance that the accounts of charities to which this consultation applies have been externally reviewed by an independent person (who has a professional accounting qualification in the case of qualified independent examination).

While an independent examination is not intended to provide the same level of assurance, in terms of the depth of the work that is carried out as an audit, an examiner must still comply with the Directions made by the Commission (the Directions) and the required content of their report is set out in the Charities (Accounts and Reports) Regulations 2008 (the 2008 Regulations). The Directions and 2008 Regulations are mandatory and apply to examinations of the accounts of both registered charities and those charities currently excepted from registration.

An examination involves a review of the accounting records kept by the charity and a comparison of the accounts presented with those records. It also involves a review of the accounts and the consideration of any unusual items or disclosures identified. Verification and vouching procedures, where an item in the accounts is checked against an original document such as an invoice or a receipt, only become necessary where significant concerns are identified from the work of the examiner, or where trustees do not provide satisfactory explanations.

Because an examiner does not act as an auditor and therefore does not test the internal financial controls operating in the charity, their report provides a more limited form of security, but it must still:

- confirm that no evidence has been found that suggests certain things have not been done by the charity, such as not maintaining proper accounting records; and
- provide a statement on specific matters that have come to their attention as the result of the examination procedures specified in the Directions.

This is a less detailed requirement than that of an audit, because an auditor is required to build up a body of evidence to support a positive statement of opinion on the accounts, including whether the accounts show a 'true and fair view'.

More information about the independent examination of charity accounts can be found in the Commission's publication *Independent examination of charity accounts: examiners* (CC32).

Increasing the choice of independent examiners available to charities that must have their accounts examined by an accountancy professional

Section 145 of the 2011 Act also enables the Minister for the Cabinet Office to add or remove organisations from the list of those whose members can carry out an independent examination on the accounts of charities with an income that is more than £250,000 (but below the threshold requiring audit).

We have received an approach from a recognised professional accountancy membership body asking if it can be added to the list of those whose appropriately qualified members can carry out such examinations. Increasing the number of professionally qualified independent examiners available will, of course, increase choice and may make it easier for the charities that need them to find one.

However, we do need to be satisfied before adding any organisation to the list that it has members that are competent to carry out a professionally qualified independent examination of a charity's accounts. In order to be considered for inclusion in the list of organisations, whose members can carry out independent examinations of the accounts of charities with an income of more than £250,000, we consider that an organisation will need to demonstrate that:

- It keeps a register of members.

  This is a publicly available database that lists individuals who are members, which is available for public view and/or has an e-mail or web page enquiry facility enable the public to check whether a person is a member of the body. The individual members will have a recognised accountancy qualification from the organisation, which will have been achieved through examination and/or accredited experience and training. The requirements for membership will include adherence to an ethical code of conduct.

- Members are required to undertake annual continuing professional education.

  Members are required to maintain and develop their knowledge and skills throughout their career in accordance with requirements decided by the membership organisation. Continuing professional education will ensure that members are responsible for keeping up to date with changes to charity law and regulation, accounting standards and the requirements of independent examination.

- There is a procedure to discipline members and for removal.

  The organisation has a robust regulatory function supported by proportionate disciplinary procedures. The organisation will investigate and assess all complaints regarding members to determine if they constitute a disciplinary matter. Members that fail to follow the regulations and guidance of the organisation may be subject to disciplinary action which may range from fines to cessation of membership.

- Members demonstrate a sufficient level of charity accounting knowledge.

  Members will have a knowledge of the law and practice that applies specifically to the accounts of charities in England and Wales. There will need to be a means by which that knowledge can be demonstrated through a requirement necessary to obtain membership and an ongoing requirement for continuing professional development.

Questions

We will be grateful for your answers to the following questions:

<u>Raising the audit financial thresholds</u>

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?*

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?*

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

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

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

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.*

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

Increasing the preparation threshold for group accounts

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?*

Increasing the choice of independent examiners available to charities that must have their accounts examined by an accountancy professional.

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?*

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.*

Part IV – Impact

Introduction

The proposed increase in both the income and the income component of the asset audit thresholds will save around 3,800 to 4,000 charities from the costs of having their accounts audited every year, depending on which asset threshold option is chosen. The independent examination that will take the place of the audit will still provide a proportionate level of scrutiny and transparency as the accounts will be examined by a person with a professional accounting qualification who can identify issues that are of concern. The accounts of those charities that are registered will continue to be available to the public on the Commission's website and both registered charities and those charities that are not required to be registered will still be legally required to send a copy of their accounts to anybody that asks for them, on payment of a reasonable copying charge.

We have prepared an Impact Assessment, available alongside this consultation document on gov.uk, for the Government's preferred option (Option 1), to increase the audit thresholds to:

- an income of more than £1 million; or
- assets worth more than £3.26 million and an income of more than £500,000.

The Impact Assessment has been submitted to the Regulatory Policy Committee for validation and is based on evidence of costs of different forms of accounts scrutiny coupled with very cautious assumptions. The estimated cost saving to charities is around £5 million per year. An overview of how this figure is calculated is below.

Raising the asset threshold to £5 million under Option 2 produces a small change in the estimated cost saving to charities. This is due to a slightly larger number of charities that would be affected. A comparable figure is calculated below.

We do not anticipate that adding further organisations to the list of professional accountancy membership bodies that can carry out independent examinations will have a significant impact on the cost. However, it will increase choice and may make it easier for charities to find professionally qualified independent examiners.

Proposed Changes

Option 1: Raising the audit thresholds to:

- an income of more than £1 million; or
- assets worth more than £3.26 million and an income of above £500,000.

Transitional costs incurred by charities as a result of the proposed changes comprise of familiarisation costs and search costs. Familiarisation costs apply to all charities irrespective of income and a monetisation of the time taken to understand the new thresholds produces a value of £4.4 million.

Search costs apply to charities, previously subject to the requirement to have their accounts audited, now looking for an independent examiner. These are calculated at £0.6 million. The best estimate for total transitional costs is therefore £5 million.

In terms of benefits, we have split charities into two categories: those with an income of between £500,000 and £1 million with assets of less than £3.26 million, and those with an income of £250,000 to £500,000 and assets above £3.26 million, both of which would be eligible for independent examination of accounts instead of a full audit.

For charities with an income of between £500,000 and £1 million and assets of less than £3.26 million, the cost of an audit is estimated at £4,750 and the cost of an independent examination at

£2,500. This means an annual saving to these charities of £2,250. Data from the Commission shows that there are 3,140 charities in this category, producing a total saving of £7.1 million.

For charities with an income of between £250,000 and £500,000 and assets of above £3.26 million, the cost of an audit is estimated at £3,500 and the cost of an independent examination at £1000. This means an annual saving to these charities of £2,500. There are 6,600 charities in this income band but the Commission does not hold data on assets held by these charities. Conservatively estimating that only 10% of charities in this income band hold assets of above £3.26 million means that 660 charities would save £2,500 each every year. This produces a total annual saving of £1.6 million.

One off transitional costs of £5 million are therefore offset against a total annual saving of £8.7 million to charities. Using the impact assessment calculator provided by the Better Regulation Executive, this produces an Equivalent Annual Net Cost to Business (EANCB) of -£5.61 million, i.e. a yearly saving of **£5.61 million**. Full calculations and evidence can be found in the Impact Assessment.

Option 2: Raising the audit thresholds to:

- an income of more than £1 million; or
- assets worth more than £5 million and an income of above £500,000.

The Impact Assessment only estimates savings under Option 1, the government's preferred option, but an adjustment to the figures used produces a comparable saving for Option 2.

The number of charities with an income of between £500,000 and £1 million and assets below £5 million is 3,340, meaning that there are 200 charities in this income band with assets between £3.26 million and £5 million that would affected by Option 2 but not by Option 1.

In terms of transitional costs, familiarisation costs would stay the same (£4.4 million) but search costs would apply to 3,340 charities instead of 3,140, producing a cost of £0.7 million and therefore total transitional costs of £5.1 million.

This would be offset by a greater benefit. The same average costs for audit (£4,750) and independent examination (£2,500) apply to these charities so the saving per charity remains at £2,250. For 3,340 charities, this produces a total annual saving of £7.5 million.

Again, the Commission does not hold data on assets held by charities in the income bracket of £250,000 to £500,000. Generously assuming that 10% of the 6,660 charities in this bracket have assets of over £5 million in value means that the saving to charities in this category stays the same at £1.6 million per year. In reality, the number of charities with assets of over £5 million would be smaller than those with assets of over £3.26 million, but keeping this figure the same allow for an easy and generous comparison of savings under Option 2 than Option 1.

Under Option 2, therefore, one-off transitional costs of £5.1 million are offset by £9.1 million in annual savings. Using the Better Regulation Executive's impact assessment calculator, this produces an Equivalent Annual Net Cost to Business (EANCB) of -£5.91 million, i.e. a yearly saving of **£5.91 million**.

The comparative savings are shown in the table below. Please note that all figures are estimates only.

Option	Costs to charities		Benefits to charities (by income)		**Net cost saving per year (using EANCB)**
	Familiarisation costs	Search costs	£250,000 - £500,000	£500,000 - £1 million	
Option 1	£4.4 million	£0.6 million	£1.6 million	£7.1 million	**£5.61 million**
Option 2	£4.4 million	£0.7 million	£1.6 million	£7.5 million	**£5.91 million**

Increasing the choice of independent examiners available to charities that must have their accounts examined by an accountancy professional

There are already 11 professional accountancy membership bodies with members who have the qualifications that enable them to carry out an independent examination of the accounts of charities with an income of more than £250,000. While the addition of one or two more such bodies will further increase the choice available to charities that need to have their accounts independently examined by a professionally qualified examiner and may make it easier for some charities to find an examiner, it is unlikely that this will have a significant impact on the cost for charities in obtaining an examination.