Cabinet Office

THE GOVERNMENT RESPONSE TO THE CONSULTATION ON CHARITY AUDIT AND INDEPENDENT EXAMINATION

Introduction

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").

Following recommendations made by Lord Hodgson in his report on the operation of the Charities Act 2006, the Government consulted on proposals to increase the above 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.

We also consulted on increasing the threshold above which parent charities must prepare group accounts from a total income of £500,000 to £1 million, as well as adding to the list of professional accountancy membership bodies whose appropriately qualified members can carry out independent examinations of the accounts of charities with an income of more than £250,000.

The consultation

56 responses were received to the consultation from a broad range of individuals and organisations, comprising charities, accountancy professionals and umbrella bodies of both sectors. A full list of respondents can be found in **Annex A**.

The consultation was open for 7 weeks from 9 December 2014 to 27 January 2015.

General feedback

1. The significant majority of consultation respondents appreciated the effect the proposals would have in decreasing the regulatory burden on charities and offered either full or qualified support. Where support was qualified, this tended to be on the subject of the asset threshold, with some wishing to go further than the Government's preferred course of action by increasing the asset threshold from £3.26 million to £5 million, and others preferring to abolish the asset threshold altogether.

2. A small proportion of respondents disagreed with the proposals on the grounds that they thought independent examination did not provide the necessary scrutiny for what they considered were often, in the income band in question, large charities with complex financial arrangements. It was argued that some independent examiners lacked training and did not always have the required skills for the task. These respondents thought the proposals would lead to less transparency and a greater risk of fraudulent activity going unnoticed.

3. Other respondents defended the robust nature of the independent examination regime and argued that it was a more appropriate form of scrutiny for charities of this size. Some respondents drew the distinction between 'lay' independent examinations and professional independent examinations, and noted that it was the remit of the latter, not the former, that the Government was proposing to extend.

4. There was a relatively even distribution of responses from individuals and organisations from both the charitable and accountancy sectors. Charities and their representatives tended strongly to support the majority of proposals, whilst accountancy professionals mostly supported the proposals. Where some proposals lacked support, this tended to be from the latter group.

Government response

5. *The Government would like to thank all those who took the time to respond to the consultation. Although only a minority of respondents answered every question in the consultation document, we received adequate responses to each to question in order to gauge the level of support.*

6. *The Government is pleased that there was an agreement from the majority of respondents that the proposed changes would have a positive benefit to charities by making the regulatory burdens placed upon them more proportionate.*

7. *We note the concerns expressed by a minority of respondents about the suitability of independent examination but believe that the independent examination regime is a robust form of financial scrutiny when practiced by suitably qualified professionals.*

8. *We intend to pursue proposals to increase the income threshold but have decided to leave the asset threshold unchanged. This is a result of both consultation responses and advice on the scope of the power to amend the asset threshold in secondary legislation.*

9. *In light of a number of requests regarding the implementation date, we have decided to bring forward the date at which these proposals become 'live' to 31 March 2015, meaning that charities who fall below the thresholds and whose accounting years end on or after 31 March can benefit immediately.*

Raising the audit financial thresholds

Question 1: Increasing the income threshold from £500,000 to £1 million

10. 41 responses were received to Question 1. 85% of respondents supported the increase in the income threshold to £1 million, whilst 15% did not.

11. Where reasons were given to support the increase, most respondents agreed with the Government's assessment that qualified independent examination is a more proportionate form of scrutiny for charities with an income of between £500,000 and £1 million.

12. Some responses from individual charities emphasised the frustration of having to divert funds towards a statutory audit that could otherwise have been spent on the charity's activities.

13. Those respondents who did not support the increase tended to express concerns at the rigour of the independent examination process and questioned whether this might lead to reduced transparency and increased risk of misuse of funds.

14. Others who disagreed with the increase attested to the value of an audit to some trustees, funders and grant-making authorities. Some pointed to the fact that charities tend to have more stakeholders than companies, hence the differences between thresholds for charities and small limited companies.

15. Those who noted the reduced degree of scrutiny that an independent examination provides, including those who responded positively to this question, thought that guidance issued by the Charity Commission should be revised and strengthened so that the duties of an independent examiner and the differences in process between an independent examination and audit are clearer.

Government Response

16. *The Government welcomes the support for the argument that professional independent examination is a more proportionate form of scrutiny for charities with an income between £500,000 and £1 million. We therefore intend to implement this change.*

17. *We would reiterate that there may be many cases where a charity is not statutorily required to have its accounts audited but may still be required to do so, for example because of a requirement in the charity's governing document or as a requirement of a funder. Moreover, a charity that is not required to have its accounts audited can still choose to do so as a means of providing additional assurance to stakeholders.*

18. *The Government will share with the Charity Commission consultation feedback offering views on how its guidance on the distinction between audit and independent examination may be improved. In particular, it is important to explain to those less familiar with accounting procedures the differences between independent examination and audit, and emphasise the benefits of an optional audit for charities where it is not a legal requirement.*

Question 2: Increasing the aggregate group income threshold for parent charities from £500,000 to £1 million

19. There were 37 responses to this question. Every respondent agreed that the aggregate group income threshold for parent charities should remain aligned with the income threshold for individual charities.

20. As such, all those who answered negatively to Question 2 (16%) did the same for Question 1, and all who answered positively (86%) also did the same for Question 1. Many of those who answered negatively indicated that they would support the increase if the income threshold in Question 1 was to increase.

21. Very few respondents felt the need to justify why the group income threshold should remain aligned with the income threshold for individual charities. Where they did, the importance of applying a simple and consistent threshold, whichever structure a charity chose to adopt, was emphasised.

Government Response

22. *The Government is pleased that the majority of respondents supported increasing the aggregate group income threshold from £500,000 to £1 million and that all respondents agreed that this threshold should be aligned with the income threshold in Question 1.*

23. *Given our intention to raise the income threshold (stated in paragraph 12), the Government intends to maintain consistency and increase the aggregate group income audit threshold correspondingly to £1 million.*

Question 3: Increasing the income component of the asset threshold from £250,000 to £500,000

24. There were 39 responses to this question. 72% of respondents supported increasing the income component of the asset threshold from £250,000 to £500,000, whilst 28% did not.

25. Of those giving reasons for their support for this proposal, it was argued that charities with an income below £500,000 that require an audit by virtue of their assets have typically received legacies or own property and therefore the potential to misuse funds is not as significant as in a charity with a large income. In this circumstance the option to choose a qualified independent examination might well be preferable.

26. Of those who had specific criticisms of raising the income component of the asset threshold and thought the current threshold to be suitable, one response argued that a theoretical charity with an investment portfolio of £16 million would, with a 3% interest yield, be inappropriately exempt from audit under the proposed threshold.

27. Another response took this argument further and questioned why, if the Government wishes to require charities with significant assets to undergo an audit generally, there should be an income component at all. This respondent emphasised the fact that a charity with an income of less than £25,000 is subject to no scrutiny whatsoever, irrespective of its assets.

28. Other respondents who did not support the increase did so because they disagreed with the asset test entirely. Please see Question 4 for a full summary and response.

Government Response

29. *The Government acknowledges the arguments put forward by some respondents to keep the income component as is or even abolish it completely. However, the income component serves to prevent otherwise small charities in possession of fixed assets (such as property, as is the case with church charities, amongst others) from the additional expense of an audit, when the risk of the misuse of funds is considered to be lower in such charities.*

30. *However, since the publication of the consultation document, the Cabinet Office has become aware that the income component of the asset threshold cannot simply be substituted and is tied to the accruals accounts preparation threshold in s.133 of the*

Charities Act 2011. This means that we would not be able to increase the income component of the asset threshold to £500,000 in secondary legislation without correspondingly increasing the threshold below which charities can choose to prepare receipts and payments accounts (as opposed to accruals accounts above the threshold) to the same value. The Government does not wish to increase the accruals accounts preparation threshold. The link between the income component of the asset threshold and the accruals accounts preparation threshold is on the face of the Charities Act 2011 and primary legislation would be required to remove it.

31. *Therefore, whilst we acknowledge both the majority support for this proposal and the concerns expressed by a significant majority, we intend not to pursue this change at this point in time. Nonetheless, we hope to revisit the question if an opportunity arises to reconfigure the asset threshold in primary legislation.*

Question 4: Keeping the asset component of the asset threshold at £3.26 million or increasing it to £5 million

32. There were 34 responses to this question. 59% of respondents chose Option 1, that the asset component of the asset threshold to stay at £3.26 million in line with the thresholds currently set out in the Companies Act 2006. 17% selected Option 2, that it should increase to £5 million. A further 24% answered the question but selected neither option.

33. The majority of respondents believed that there should be consistency between the asset-based audit threshold for charities and companies. This included some of those who selected Option 2, who said they were doing so because they believed that the company thresholds were due to be increased following a recent consultation by the Department of Business, Innovation and Skills (BIS). One respondent suggested linking the two thresholds explicitly in legislation.

34. Of those who selected Option 2 for other reasons, some cited the increase in property prices by inflation. This was of particular concern for charities in possession of churches or community premises, especially in London and the South East of England where property prices have increased most significantly.

35. The majority of those who chose neither option argued that the asset threshold should be abolished completely, with some referencing Lord Hodgson's initial recommendation. These respondents argued that the asset test has little or no regulatory value and causes excessive confusion.

36. One respondent who noted the frustration of property ownership triggering the asset threshold thought that assets should be redefined to include only liquid assets.

Government Response

37. *The Government agrees with the majority of respondents on the preference for consistency between the asset threshold in charity and company law. This is especially important for those charities who are also registered as companies. For this reason, the Government intends to keep the asset component of the asset threshold at £3.26 million for now.*

38. *The Department of Business, Innovation and Skills (BIS) published a consultation in December 2014 on audit regulations in the context of the EU and wider reforms. One of the questions asked whether the small companies audit exemption thresholds should remain as they are or be increased in line with those for the small companies accounting regime. Any changes are likely to be made "before the end of 2015" but we would not want to act at this point to presuppose the outcome of BIS's consultation. Should the thresholds change, we would like to revisit this question, including the possibility of linking the asset component of the asset threshold in s.144 (1)(b) of the Charities Act 2011 explicitly to the Companies Act 2006 through primary legislation.*

39. *The Government accepts that the asset test for companies' audit exemption is not entirely comparable to that for charities, nor should it be. We would defend the principle that charities with significant assets, whether they be fixed or otherwise, should be subject to a statutory audit to prevent the misuse of significant charitable assets.*

Question 5: Potential difficulties that might arise

40. A minority of respondents noted potential difficulties, whether in direct answer to this question or in general comments elsewhere. Those issues related to specific thresholds are addressed in the relevant questions elsewhere.

41. The most common concern was about the implementation date of the proposals. Most of these respondents made the point that, because most charities have accounts ending 31 March, savings from the proposals as they currently stand would not be made for a long time. Bringing the implementation date forward from 6 April would provide a cost saving to charities very quickly.

42. Four respondents highlighted the fact that the income threshold for charities in Scotland and Northern Ireland, where charity law is devolved, currently stands at £500,000 and that we would therefore be creating a discrepancy.

43. Four respondents raised the issue of Statements of Regulatory Practice (SORPs) for Charity Accounting. Two respondents argued that these proposed changes should have been aligned to the new Statements of Regulatory Practice (SORP) for Charity

Accounting, which came into force on 1 January 2015, to minimise confusion. Two others emphasised that, given some of the current disclosure exemptions are linked to the audit thresholds, the joint-SORP-making body should review whether these links should continue to apply in the context of increased thresholds.

44. A number of respondents were concerned about the lack of understanding around the assurance that an independent examination provides (see paragraph 11) but one respondent raised the more general concern of public trust and confidence upon which charities depend. The respondent suggested that a flag should be placed on charities' webpages on the Charity Commission website to identify what form of scrutiny their accounts had been subjected to with an explanation of what each form involves.

Government Response

45. The Government normally brings new regulation into effect on Common Commencement Days (CCDs), which for domestic measures are on either 6 April or 1 October. This helps businesses - and charities - prepare for forthcoming regulatory changes. However, we accept the point made by several respondents that there would be a significant cost saving to charities if the proposals could come into effect six days earlier on 31 March, which one respondent noted would be over £5 million. We therefore propose to implement the changes on 31 March 2015. This would mean that all charities whose accounting years ended on or after this date would be able to apply the new thresholds in deciding which form of scrutiny is appropriate or necessary.

46. The Government appreciates that these measures would create a discrepancy between audit thresholds in different parts of the UK. This is unavoidable, given that charity law is devolved in Scotland and Northern Ireland, if we still aim to benefit all those charities that are registered in England and Wales. A response from the Office of the Scottish Charity Regulator indicated that it believes there are around 100 charities registered in both Scotland and England and Wales with an income of between £500,000 and £1 million. We will need to be clear that these charities still require an audit in order to comply with Scottish charity law requirements.

47. We accept that combining this deregulatory change alongside the introduction of the new SORPs would have been simpler, but the timing and processes involved meant that this wasn't possible this time. We will bear this point in mind in relation to any future changes. We agree that some of the links between current disclosure exemptions and audit thresholds might require consideration in light of the audit threshold changes and will invite the joint-SORP-making body to explore this.

48. The Government wishes to make the financial controls on charities as transparent as possible and is interested in the idea proposed by one respondent of flags and explanations on charities' webpages on the Charity Commission website. We will ask the Charity Commission to consider this proposal.

Question 6: The estimated costs and cost savings

49. There were 24 responses to this question. 71% of respondents agreed with the estimated costs and savings or thought they were reasonable, and 29% disagreed. Of those who disagreed, three respondents thought the cost savings to charities were overestimated and three thought they were underestimated. One respondent thought the savings to charities by choosing an independent examination over an audit were overstated but that the transitional costs were also overstated.

Government Response

50. *The Government is pleased at the majority approval of the estimated costs and cost savings and is grateful for the provision of examples to substantiate this. It may well be the case that some costs are overestimated and some costs underestimated, and we accept that there could be significant variations between charities. Where there was uncertainty we tended to be cautious in our estimates.*

51. *Nonetheless, the Government is pleased that net savings to charities are indisputably significant with comparably low familiarisation costs.*

Question 7: Any other comments

52. Most comments relating to individual thresholds have already been summarised and addressed. There are several outstanding comments that the Government will respond to below.

53. One respondent noted that the law still requires the appointment of an individual, rather than a firm, as an independent examiner. It was argued that this may become inappropriate as the size of charities that can be subject to an independent examination increases.

54. One respondent argued for a corresponding increase in the threshold below which a charity could have its accounts independently examined by someone not professionally qualified. However, the omission of this threshold for 'lay' independent examination from the consultation proposals was commended by several other respondents.

Government Response

55. *The Government notes the point that it may be suitable under the new proposals to appoint a firm of independent examiners rather an individual. Such a change, however, would require primary legislation and cannot be taken forward as part of these changes*

at this time, but may warrant further examination in future if a suitable legislative opportunity arises.

56. *The Government does not plan to increase the threshold for 'lay' independent examination as we believe that it does not provide sufficient scrutiny for charities with an income of more than £250,000.*

<u>Increasing the preparation for group accounts</u>

Question 8: Increasing the threshold for preparation of group accounts from £500,000 to £1 million

57. 28 responses were received to this question. 82% supported increasing the threshold for the preparation of group accounts from £500,000 to £1 million, whilst 18% did not.

58. Almost all respondents answered this question in the same way they answered Question 2, not wishing to create a discrepancy between the two thresholds. Some respondents commented on the unsuitability of independent examination for group accounts, as a discrepancy would create this possibility for the first time.

59. Two respondents thought the group income threshold in Question 2 should be increased but nonetheless answered no for this question. One argued that preparation of group accounts should be expected with an income of £500,000 and that an independent examination was a perfectly adequate form of scrutiny for such accounts. The other argued that the threshold for the preparation of group accounts should be aligned with the equivalent threshold for companies on the basis that the requirement is a significant administrative burden and an unnecessary financial cost for small charities.

Government Response

60. *The Government is pleased at the majority support shown for this proposal. Not wishing to create a discrepancy with the aggregate group income threshold for the above reasons, we intend to pursue this proposal.*

61. *We acknowledge the concerns expressed but would reiterate that any parent charity that wishes to prepare group accounts in order to satisfy stakeholders is welcome to do so. We also feel that, after discussion with accountancy professionals, an audit is more suited to the complexity of group accounts than independent examination.*

62. *The Government agrees with the argument that the preparation of group accounts can be an expensive and onerous burden, but we feel that parent charities with a group income of over £1 million can no longer be thought of as small. It is for this reason that we intend to increase the threshold from £500,000 to £1 million.*

Increasing the choice of independent examiners

Question 9 and 10: Adding to the list of professional accountancy membership bodies whose members can carry out independent examinations

63. The consultation document referred to the fact that the Cabinet Office has been contacted by a recognised professional accountancy membership body - the Institute of Financial Accountants (IFA) - 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. The IFA have since provided us with documentation to show that they meet the criteria set out in the consultation document. The consultation also invited applications from any other professional accountancy bodies that considered themselves suitably qualified to be added to the list of recognised bodies.

64. There were 16 responses to this question. Of these, 9 were in support of the IFA's application to become an approved body for professional independent examinations.

65. One response was received from the Certified Public Accountants Association (CPAA). The response indicated that the CPAA met the criteria and the respondent has provided documentation to support this. Another response nominated the Chartered Institute of Public Finance and Accountancy (CIPFA), although this body is already on the list of approved bodies for professional independent examinations.

66. Others who answered this question either expressed concern that unqualified or unsuitable persons might be authorised to independently examine the accounts of charities with an income of more than £250,000, or conversely, to support a general extension of the list of bodies in the interests of choice and healthy competition.

Government Response

67. *The Government is satisfied that members of the IFA are sufficiently competent to carry out a professional independent examination of charity accounts where the charity's income is over £250,000 and that the organisation itself meets the criteria for inclusion in s.145 of the Charities Act 2011. We therefore intend to add the IFA to this list.*

68. *We are also willing to add the CPAA to this list subject to their submission of sufficient evidence to show that their members are similarly qualified and that the organisation itself meets the same criteria. Applications from other suitable bodies continue to be welcomed at any time and would be considered in relation to any future changes.*

69. *The Government wishes to reassure those with concerns that adding professional accountancy membership bodies to the list in s.145 of the Charities Act 2011 will in no*

way lead to unqualified persons being able to conduct independent examination of charity accounts where income exceeds £250,000.

Next Steps

70. *In light of the consultation responses, the Government intends to pursue the following proposals:*

    a. *increasing the income threshold from £500,000 to £1 million;*
    b. *increasing the aggregate group income threshold at which parent charities should have group accounts audited from £500,000 to £1 million;*
    c. *increasing the preparation threshold for group accounts from £500,000 to £1 million;*
    d. *adding the Institute of Financial Accountants and the Chartered Public Accountants Association (subject to the submission of appropriate evidence) to the list of recognised professional accountancy membership bodies whose appropriately qualified members can carry out independent examinations of the accounts of charities with incomes that are more than £250,000.*

71. *The Government intends to leave both the income and asset component of the asset threshold unchanged at this point in time.*

72. *A statutory instrument will be drafted and will be laid in Parliament with sufficient time before dissolution on 30 March 2015. The changes should come into effect on 31 March 2015.*

ANNEX A

List of consultation respondents

Archie Gilmour
Association of Charitable Foundations
Association of Charity Independent Examiners
Association of Church Accountants & Treasurers
Association of School and College Leaders
Baker Tilly UK Audit LLP
Bond
Cathy French
Certified Public Accountants Association
Charity Finance Group
Deloitte LLP
Dick Maule FCA
Dr H T A Yongo
Dr Rowland N. Sunday
Ellison Services
G P Brookes
haysmacintyre
Ian Hornsey
Institute of Financial Accountants
Jill O'Hagan
John O'Brien
Kingston Smith LLP
KM Chartered Accountants
Les Miller
Margaret Birse
MHA MacIntyre Hudson
Michael J. Etheridge
Moore Stephens LLP
National Council for Voluntary Organisations
North Hertfordshire and District Citizens Advice Bureau
Nova Wakefield District
Office of the Scottish Charity Regulator
Olubunmi Esan
Paul Marker FCA
Peter Arnold
Peter Gowland
Peter Kelly
Professor Gareth G Morgan
Reeves & Co LLP
Relate Dorset and South Wiltshire
Rupert Blomfield
Shabbir H. Mohamedali
Simon Cramp
South Tynedale Railway Preservation Society
Stewardship
The Association of Accounting Technicians
The Association of Chartered Certified Accountants
The Bridge East Midlands
The Chartered Institute of Public Finance and Accountancy
The Institute of Chartered Accountants in England and Wales
The Institute of Chartered Accountants Scotland
The Institute of Chartered Secretaries and Administrators
The Law Society
Trinity-at-Bowes
Warner Wilde
Warwickshire Association of Youth Clubs
Zeeshan Rizvi