

19 August 2024



Scottish charities and audit requirements under the Charities Accounts (Scotland) Regulations 2006: The case for reform

Comments to OSCR from ICAS

Scottish charities and audit requirements under the Charities Accounts (Scotland) Regulations 2006: The case for reform

About ICAS

The Institute of Chartered Accountants of Scotland (ICAS) is a global, professional membership organisation and business network for Chartered Accountants. It's also an educator, regulator, examiner and a professional awarding body.

ICAS' diverse membership is made up of over 24,000 world class business professionals who work in the UK and in more than 80 countries around the globe. Members of ICAS are also known by the letters CA, an exclusive professional designation in the UK.

ICAS members operate at the forefront of ethical and sustainable business. Educated, regulated, and led by the highest standards of ethical leadership since 1854, they are at the top of their game. They are trusted professionals, who transform business and support one another for the greater good.

Acting in the public interest is the guiding principle of all that ICAS does and we continually work to maintain trust in the finance profession. That ethos is enshrined in the ICAS Code of Ethics – which applies to all members, students and member firms, and is underpinned by our Royal Charter commitment.

ICAS is a member of the Chartered Accountants Worldwide Network, a global family that brings together the members of 15 leading institutes to create a community of over 1.8 million Chartered Accountants and students in more than 190 countries.

Any enquiries should be addressed to Christine Scott, ICAS Head of Charities and Reporting via connect@icas.com.

Executive summary

Following discussions with members of the staff team at OSCR in March 2024, ICAS has set out the case for reforming the Scottish charity audit threshold.

We believe that the Scottish charity audit threshold is no longer proportionate compared to 2006 when the Charities Accounts (Scotland) Regulations 2006 (the 2006 accounting regulations) were implemented. This is for two key reasons:

- (i) The reduced complexity of charities currently falling within the audit regime; and
- (ii) The evolution of auditing standards.

We welcome the Scottish Government's commitment to a public consultation on increasing the audit threshold with a focus on the gross income criterion of £500,000 or more per year. However, in [our response](#) to the Scottish Government's recent consultation on its *Review of charity regulation* we have called for other aspects of the Charities Accounts (Scotland) Regulations 2006 (the 2006 accounting regulations) to be included within the scope of the review. In particular, we would like to see a strategic approach to reviewing the external scrutiny requirements, encompassing both the independent examination and audit regimes.

Reduced complexity of charities subject to audit

A charity with a gross income of £500,000 per annum today is a less sophisticated organisation compared to a charity of the same size in 2006. Comparatively, a charity will have fewer staff, including fewer staff with financial management and accountancy experience, and will have simpler operations.

Essentially, inflation means that some charities now falling within the audit regime are smaller in scale than was the case in 2006. We have prepared an illustration of the impact of the passage of time on the relative sophistication of a charity in 2023 compared to 2006. The illustration is set out on page 6.

Impact of increasing the audit threshold to include income of £1 million or more

We have examined, as far as possible from information available in OSCR's *Sector Overview* report (end of quarter 4 2023)¹ what the impact on the sector would be of increasing the gross income criterion from £500,000 or more to £1 million or more. 'Impact' in this context is considered in terms of the percentage of charities that would no longer need an audit and the extent to which the sector's income would continue to be audited in percentage terms if the gross income criterion was raised to £1 million or more.

Our analysis indicates that raising the income criterion to gross annual income of £1 million or more would remove less than 3%² of Scottish charities³ by number from the audit regime. While we have not been able to distinguish the amount of income received by Scottish charities with an income of between £500,000 and £999,999 from Scottish charities with an income of £1 million or more, we estimate that around 90% of income would continue to be audited if the income criterion was raised to £1 million.

The design of the audit threshold

In addition to the audit threshold's size criteria, the absence, unlike the requirements of the Companies Act 2006, of a year's grace from a one-off breach of the threshold means that a charity that is not on a growth trajectory may need to appoint an auditor at short notice for one year only.

Single year audits bring their own challenges, and we believe that the cost of having an audit for a single year before reverting back to independent examination outweighs the benefits to the charity and its stakeholders.

Potential for reforming the independent examination regime

We believe that there is scope to reform, i.e. to strengthen, the independent examination regime, to address reservations about increasing the audit threshold. This could be achieved by mandating the work an independent examiner needs to undertake, for example, by adopting an approach similar to the approach followed in England and Wales, where the Charity Commission for England and Wales (CCEW), issues formal Directions.

It may also be reasonable, given the maturity of Scottish charity regulation, to consider the introduction of an independent examination threshold to remove the smallest charities from independent examination to ensure the regime is proportionate and sustainable.

The evolution of auditing standards

Auditing standards in the UK have evolved since 2006, with the aim of improving audit quality and achieving greater consistency of practice through strengthening requirements.

The evolution of auditing standards means that an audit has become a more onerous engagement, less well suited to smaller entities. We question whether extant auditing standards are scalable and proportionate for the audit of some charities falling within the audit regime under the 2006 accounting regulations.

There are currently two International Quality Management Standards (UK) and 36 International Standards on Auditing (ISAs) (UK) that auditors must apply to all statutory audits they undertake.

¹ OSCR's *Sector Overview* report (end of quarter 4 of 2023)

² At the end of quarter 4 of 2023, 568 out of 23,742 Scottish charities had an annual income of between £500,000 and £999,999, *OSCR's Sector Overview report* (end of quarter 4 of 2023) - Income breakdown by numbers on the register (page 11)

³ Scottish charities are defined by OSCR as charities only registered in Scotland i.e. cross border charities are excluded from the definition

Scottish charity and company audit thresholds

Traditionally, the Scottish charity audit threshold has been significantly lower than the company audit threshold, but the differential has increased significantly since the 2006 accounting regulations were implemented.

A further increase in the company law audit threshold is a possibility. Prior to the General Election in July 2024, we had expected an increase from 1 October 2024. But following the change in government further clarification about any change is awaited from the Department for Business and Trade (DBT). The proposed increase by the previous government would have removed around 8,000 companies from the company audit regime.

Over the past 20 years or so increases in the company law threshold have resulted in a fall in the number of audit firms. This is a trend we expect to continue with future threshold changes and is likely to add to the challenges charities are experiencing in appointing an auditor.

Companies have a year's grace when exceeding the size criteria for an audit so that a company which may not be on a growth trajectory doesn't have to have an audit until the size criteria are breached for two consecutive years. This additional concession is absent from the Scottish charity law threshold, but charities registered with the CCEW can apply to the CCEW for dispensation from audit.

The decline in the number of registered audit firms in the UK and Republic of Ireland

There is a long-term downward trend in the number of firms in the UK and the Republic of Ireland (ROI) registered to undertake audit work and this is having an impact on the availability of audit services to Scottish charities. Information on the number of audit firms is gathered from each Recognised Supervisory Body and is not further analysed geographically.

The FRC produces a paper each year on *Key facts and trends in the accountancy profession*⁴. A high-level analysis of these papers highlights that:

- Between 31 December 2001 and 31 December 2022, ICAS registered audit firms fell from 482 to 128 or 73%.
- In comparison, UK wide and ROI audit registered firms, in total, fell from 11,172 to 4,310 in the same period: a fall of 61%.

Recent experience of members of the ICAS Charities Panel

From the experience of Charities Panel members who have trustee or FD roles, tender exercises are not always proving successful, sometimes with only the incumbent auditor making a submission. This deprives charities of the opportunity to change auditor. There are risks associated with limited or no competition, including risks to audit quality and the risk of increased audit fees.

From an auditor perspective audit firms are planning charity audits at least a year ahead if not more. This means that unless a charity issues an invitation to tender a year or more in advance of seeking to change their auditor, audit firms are not in a position to submit a proposal.

Case studies

We have written up two case studies based on queries we have received from audit firms this year. The main challenge in both case studies is the design of the audit threshold i.e. the absence of a year's grace from a one-off breach in the size criteria for audit following the unexpected receipt of legacy income.

⁴ [*Key facts and trends in the accountancy profession*](#) publications are available on the FRC's website

Introductory remarks

On behalf of ICAS, our Charities Panel welcomes the opportunity to provide written comments to OSCR highlighting our concerns about the audit regime for charities in Scotland.

We understand from discussions in March 2024 with members of the staff team at OSCR that, to date, our concerns as well as those expressed by the charity sector about auditor availability are not currently borne out by way of a significant increase in the late filing of trustees' annual reports and accounts.

While we are surprised by this, we remain of the view that the audit requirements placed on charities under the Charities Accounts (Scotland) Regulations 2006 (the 2006 accounting regulations) are too onerous, including the size criteria. We believe that the audit and independent examination requirements should be updated to ensure that the external scrutiny requirements placed on charities are both proportionate and sustainable.

Also, in our March 2024 discussions with members of the staff team at OSCR we highlighted that another consequence of audit market conditions could be that charities are remaining with their existing auditor in circumstances where they may otherwise have preferred to undertake a tender exercise for both governance and value for money considerations.

We believe that the Scottish charity audit threshold is no longer proportionate compared to 2006 when the 2006 accounting regulations were implemented. This is for two key reasons:

- (i) The reduced complexity of charities currently falling within the audit regime; and
- (ii) The evolution of auditing standards.

In our evidence we explore these two issues and other related matters under the following headings:

- The Scottish charity law audit threshold
- Reduced complexity of charities subject to audit
- Impact of increasing the audit threshold to include income of £1 million or more
- The design of the audit threshold
- Potential for reforming the independent examination regime
- The evolution of auditing standards
- Scottish charity and company audit thresholds
- The decline in the number of registered audit firms in the UK and Republic of Ireland
- Recent experience of members of the ICAS Charities Panel
- Case studies

In the comments that follow we set out evidence in support of revising the audit threshold. In August 2023, we [wrote to the Cabinet Secretary for Social Justice](#) calling for further charity law reform including changes to the audit threshold.

The Scottish charity law audit threshold

We refer to the Scottish charity law audit threshold throughout our paper. The threshold applies to all charities included on the Scottish Charity Register, including cross-border charities with operations in Scotland who are primarily based outside of Scotland.

Under the 2006 accounting regulations (regulation 10), a charity must receive an audit by a registered auditor if in any financial year:

- It has gross income of £500,000 or more, or
- The aggregate value of its assets (before deduction of liabilities) at the end of the financial year exceeds £3,260,000, or
- It is required to do so by the constitution of the charity, any other enactment, or on the instruction of its trustees.

Gross income is defined in the 2006 accounting regulations as:

“Incoming resources of the charity in all restricted and unrestricted funds but excluding the receipt of any donated asset in a permanent or expendable endowment fund.”

The audit threshold has not been amended since the 2006 accounting regulations were implemented on 1 April 2006, except for the aggregate value of assets which increased from £2.8 million for accounting periods beginning on or after 1 April 2011.

Reduced complexity of charities subject to audit

A charity with a gross income of £500,000 per annum today is a less sophisticated organisation compared to a charity of the same size in 2006. Comparatively, a charity will have fewer staff, including fewer staff with financial management and accountancy experience, and will have simpler operations. Essentially, inflation means that some charities now falling within the audit regime are smaller in scale than was the case in 2006, when the 2006 accounting regulations were implemented.

We have prepared an illustration, set out below, of how the passage of time may have impacted on the relative size and sophistication of a charity with an annual income of £500,000 in 2023 compared to a charity with an annual income of £500,000 in 2006.

Illustration of impact of the passage of time on the relative sophistication of a charity in 2023 compared to 2006

For charities, except grant giving charities, staff costs are normally a significant area of spend. We have developed an illustration showing how a charity in 2023 with an income of £500,000 may compare to a charity with an income of £500,000 in 2006. 2023 is used as the comparative year as this is the latest period earnings data is available for. We've also assumed that all income is spent during the period.

We have assumed for the purposes of the illustration that staff costs represent 70% of expenditure by both charities, meaning that £350,000 is spent on staff costs and £150,000 on other expenditure. We have also calculated the average cost of employing a member of staff on an average salary in 2006 and 2023.

Based on our calculations, the average cost of employing someone full-time in 2006 was £26,569 and in 2023 it was £39,394.

In 2006, a charity with an income of £500,000 spending £350,000 on staff could employ 13.2 full-time staff with average salaries. But by 2023, a charity of the same nominal size spending £350,000 on staff could only employ 8.9 full-time staff, a reduction of 32.6% in staff resources.

A charity spending £150,000 on non-staff costs in 2006 has greater spending power than a charity spending £150,000 in 2023. Between 2006 and 2023, inflation averaged 3% per year, meaning that spending of £150,000 in 2006 is equivalent to a spending power of £248,089 in 2023. This equates to a reduction in spending power by 2023 of 65.4%.

While the illustration doesn't represent real charities, it shows that inflation means a charity with an income at or above the audit threshold in 2023 will have an operation that is comparatively smaller and less sophisticated than a charity with the same income in 2006. This means that there is a strong likelihood that the impact of inflation, without considering other factors, means an audit is no longer a proportionate form of scrutiny for some charities falling within the scope of audit.

Assumptions used in preparing the illustration

The following assumptions have been made in preparing the illustration:

- Salary costs are based on median annual earnings for a full-time annual salary in the UK, plus employer on costs i.e. employer national insurance and pension contributions (2023 only).
- While data on the median annual earnings for a full-time annual salary in Scotland for 2023 is publicly available, comparative data is not available for 2006. In 2023, median annual earnings in Scotland were slightly higher than for the UK as a whole.

- Earnings data is published by Statista⁵.
- Estimated employer on costs for both employer National insurance (NI) and auto-enrolment pension contributions were added to the figures for median annual earnings for a full-time annual salary in the UK.
- For 2023, an on-line employer NI calculator was used⁶. However, no on-line calculator was available for employer NI in 2006. Therefore, employer NI for 2006 was calculated using UK Government statistics⁷.
- For 2023, minimum employer pension contributions based on qualifying earnings were calculated. Pensions auto-enrolment commenced in 2012, so no employer on costs relating to pension contributions have been assumed for 2006. Information on minimum employer contributions and on qualifying earnings is available from The Pensions Regulator⁸.
- The Bank of England's inflation calculator, which applies the Consumer Price Index (CPI), was used to illustrate the impact of inflation on non-staff costs⁹.

We are not suggesting that CPI alone should be applied to any uplift to the financial criteria for the audit threshold. Other factors should also be considered, for example; including a buffer above inflation to allow for future price increases; and whether an audit is the appropriate form of scrutiny, once increases for inflation to date have been considered.

Prior to the July 2024 General Election, DBT proposed an uplift of 50% to the financial criteria of the company audit threshold. This represents inflation plus a percentage increase over and above inflation since the thresholds were last updated so that the thresholds remain proportionate for a period of time.

Impact of increasing the audit threshold to income of £1 million or more

While we have not made any recommendations about how much the financial criteria for having an audit should increase, we have examined, from information available in OSCR's *Sector Overview* report (end of quarter 4 2023)¹⁰, what the impact on the sector would be of increasing the gross income criterion from £500,000 or more to £1 million or more. 'Impact' in this context is considered in terms of the percentage of charities that would no longer need an audit and the extent to which the sector's income as a whole would continue to be audited if the gross income criterion became income of £1 million or more.

Our analysis focuses on the gross income criterion of the audit threshold. However, we acknowledge that there will be charities that require an audit who have income of less than £500,000 but require an audit due to the value of their assets. We do not believe that this will impact in a significant way on our analysis.

On 31 December 2023, nearly 7% of Scottish charities¹¹, or 1,636 by number, had an income of £500,000 or more, including over 4%, or 1,068 by number, with an income of £1 million or more¹².

In 2023, the combined annual income for Scottish charities was around £15.55 billion¹³. The nearly 7% of Scottish charities with an income of £500,000 or more represented nearly 93% (or £14.45 billion) of the sector's income. Specialist charities represented approximately 56% (or £8.68 billion)¹⁴ of the sector's income meaning that non-specialist charities with an income of £500,000 or more, represented approximately 44% of annual income (or £6.87 billion).

⁵ [Full time annual earnings in the UK, Statista](#)

⁶ [On-line employer National Insurance calculator, 123 Financials](#)

⁷ [HM Revenue and Customs \(HMRC\) statistics relating to the main features of National Insurance contributions](#)

⁸ [TPR information on Making contributions to your pension scheme](#)

⁹ [Bank of England Inflation calculator](#)

¹⁰ OSCR's *Sector Overview* report (end of quarter 4 of 2023)

¹¹ Scottish charities are defined by OSCR as charities only registered in Scotland i.e. cross border charities are excluded from the definition

¹² [OSCR's Sector Overview report](#) (end of quarter 4 of 2023) – Income breakdown by numbers on the register (page 11)

¹³ [OSCR's Sector Overview report](#) (end of quarter 4 of 2023) – Gross annual income (page 12)

¹⁴ [OSCR's Sector Overview report](#) (end of quarter 4 of 2023) – Breakdown of gross income by type of charity (page 13)

Specialist charities, registered as charities solely in Scotland, are universities, further education colleges, registered social landlords and arm's length organisations established by local authorities. Such organisations will likely need to be audited regardless of any uplift in the Scottish charity audit threshold. We've also assumed based on experience that all specialist charities are included within the over 4% of Scottish charities with an income of £1 million or more per year.

Therefore, raising the income criterion to gross annual income of £1million or more would remove less than 3%¹⁵ of charities by number from the audit regime. While we have not been able to distinguish the amount of income received by charities with an income of between £500,000 and £999,999 from Scottish charities with an income of £1 million or more, we estimate that around 90% of the income of Scottish charities would continue to be subject to audit if the income criterion was raised to £1 million. This estimate is based on the number of charities with an income of between £500,000 and £999,999 on 31 December 2023 and calculating the minimum and maximum income in total that those charities could have received.

NB. In this paper, we draw on information from OSCR's *Sector Overview* reports for quarter 4 of 2023 and for 2021. This is so that comparative information can be used where relevant to illustrate some of the points we are making. The *Sector Overview* report for 2021 has been used as there was no *Sector Overview* report for 2022. We note that *Sector Overview* reports are now provided quarterly, but for consistency information provided for a full calendar year or at the end of a calendar year is referred to in our paper.

The design of the audit threshold

In addition to the audit threshold's size criteria, the absence, unlike the requirements of the Companies Act 2006, of a year's grace from a one-off breach in the size criteria means that a charity which is not on a growth trajectory may need to appoint an auditor at short notice for one year only. The case studies included below illustrate the challenges charities have experienced in this regard.

A one-off breach could occur, for example, due to unexpected legacy income being received or receivable during the accounting period or due to the award of a multi-year grant.

Also, where a charity is aware that a legacy is due but cannot be reliably measured before the end of the accounting period, post balance sheet receipt means that a charity's income must be adjusted after the balance sheet date but before the accounts are finalised. In this scenario, it isn't possible to know that the income criterion for audit has been breached until after the end of the accounting period.

The award of a grant intended to fund multiple years of a charity's operations could result in a one-off breach. This can occur if the grant does not have conditions attached sufficient to prevent its full recognition at the time of the award. This is a consequence of the performance model of accounting for grants being a requirement for charities using the Charities SORP (FRS 102).

Recognition of grant income under the performance model is a challenging area of accounting even for professionally qualified accountants, so this is an area where charity staff may not realise the consequences of the award of a multi-year grant until late on in the reporting cycle.

Single year audits bring their own challenges, and we believe that the cost of having an audit for a single year before reverting back to independent examination outweighs the benefits to the charity and its stakeholders.

For any audit firm, an audit engagement for a single year is a less attractive proposition than a recurring engagement. This is due to the upfront effort required to establish an engagement which cannot then be recouped in future years. This is particularly the case when an audit for a single year cannot be secured from the same source as the independent examination meaning that any firm appointed to undertake the audit has more work to do to build up client knowledge.

¹⁵ At the end of quarter 4 of 2023, 568 out of 23,742 Scottish charities had an annual income of between £500,000 and £999,999. [OSCR's Sector Overview report](#) (end of quarter 4 of 2023) - Income breakdown by numbers on the register (page 11)

A further disadvantage of having a one-off audit is that it can risk the charity receiving a qualified 'except for' audit opinion due to there being a limitation on the scope of the audit. An auditor is required to obtain sufficient appropriate audit evidence in support of a charity's opening balance sheet. However, it is not always possible to obtain sufficient appropriate audit evidence in support of opening balances where the previous year's accounts were unaudited. For example, for a charity holding a material level of stock, there would have been no opportunity for the auditor to attend the stocktake and a possibility that there are no suitable alternative audit procedures the auditor could undertake.

A qualified auditor's opinion in the above scenario could raise alarm bells with a charity's funders even though it is not an indication of financial mismanagement at the charity or another significant problem.

If an audit was required the following year, the qualification would normally fall away. However, for a charity requiring an audit on a one-off basis, there is no opportunity to receive a clean auditor's opinion unless the charity decides to continue to receive an audit on a voluntary basis. For an organisation which is growing, falling within the audit regime can be a proportionate burden to be navigated, but for a charity which is not, being in the position of having a qualified auditor's opinion could have disproportionate negative consequences.

N.B. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions made on the basis of an entity's accounts.

Potential for reforming the independent examination regime

We recognise that an increase in the audit threshold would mean an increase in the number of charities requiring an independent examination, but it would also mean that the level of scrutiny required for those charities moving from audit into independent examination would be proportionate. Approximately 93%¹⁶ of Scottish charities¹⁷ by number meet the size criteria for independent examination, so independent examination is already a form of scrutiny considered by policymakers to be appropriate for the majority of the sector.

However, we believe that there is also scope to reform, i.e. to strengthen, the independent examination regime, to address reservations about increasing the audit threshold. This could be achieved by mandating the work an independent examiner needs to undertake, for example, by adopting an approach similar to the approach followed in England and Wales, where the CCEW, issues formal Directions. It would, of course, be necessary to establish if such a move would require changes to the 2006 accounting regulations and/ or the Charities and Trustee Investment (Scotland) Act 2005.

It may also be reasonable, given the maturity of Scottish charity regulation, to consider the introduction of an independent examination threshold to remove the smallest charities from the regime on the grounds that it may not be proportionate or sustainable to require all charities not receiving an audit to receive an independent examination. Charities solely registered in England and Wales with an income of £25,000 or less are not required to have an independent examination.

We remain of the view that the extant audit threshold is not sustainable even though a 'crisis' in late filing is not currently being experienced. There are several reasons for this, and we would highlight that changes in the audit market more generally mean that it is more challenging for audit firms to serve the charity sector at a price that is sustainable for those firms and affordable for charities. Therefore, the economic viability of charity audits at or around the Scottish charity threshold will become ever more challenging. As a positive, increasing the audit threshold and strengthening the independent examination regime, may create scope for accountancy firms to provide independent examination services to charities between the old audit threshold and a new higher threshold which are economically viable for both firms and charities. However, we recognise that supply issues within the audit market alone are not sufficient to drive a change in policy.

Another key matter to consider is the views of grant-makers and other funders of potential changes to the external scrutiny regime, in particular, how they would view a reduction in the level of assurance

¹⁶ [OSCR's Sector Overview report](#) (end of quarter 4 of 2023) – Income breakdown by numbers of the register (page 11).

¹⁷ Scottish charities are defined by OSCR as charities only registered in Scotland i.e. cross border charities are excluded from the definition.

on the accounts of charities moving from audit to independent examination, as a consequence of a threshold change. An audit provides reasonable assurance which is a high-level of assurance, while an independent examination provides limited assurance. It would therefore be important for any review of the external scrutiny regime to set out why any changes are considered to be proportionate so that funders maintain confidence and trust in charity accounts.

The evolution of auditing standards

Auditing standards in the UK have evolved since 2006, with the aim of improving audit quality and achieving greater consistency of practice through strengthening requirements.

The UK's strategy for achieving this is the adoption of and continued alignment with the International Auditing and Assurance Standards Board's (IAASB's) International Standards on Auditing (ISAs). ISAs were adopted for use in the UK for periods commencing on or after 15 December 2004. ISAs contain both requirements and material about how to apply those requirements. ISAs adopted for use in the UK, by the UK Financial Reporting Council (FRC), are known as ISAs (UK). ISAs (UK), initially, ISAs (UK and Ireland) replaced Statements of Auditing Standards, issued by the FRC.

There are currently two International Quality Management Standards (UK) and 36 ISAs (UK).

In this section we highlight how the evolution of auditing standards means that an audit is now a more onerous engagement, less well suited to smaller entities. We question whether extant auditing standards are scalable and proportionate for the audit of some charities falling within the audit regime for Scottish charities.

Our point is most clearly illustrated by the development by the IAASB of an ISA for Less Complex Entities (LCE). The IAASB states that "The ISA for LCE is a standalone global auditing standard designed specifically for smaller and less complex businesses. Built on the foundation of the International Standards on Auditing (ISAs), audits performed using this standard provide the same level of assurance for eligible audits: reasonable assurance."¹⁸

This is recognition in itself of the onerous nature of an audit under modern high quality auditing standards. The ISA for LCE was published in December 2023 and is available for jurisdictions to adopt, for the audit of accounting periods commencing on 1 January 2025 or beyond. At the time of writing the FRC has indicated that it has no plans to pursue the adoption of the ISA for LCE in the UK. However, ICAS is supportive of its adoption for use in the UK.

In the *Basis for Conclusions*, prepared by IAASB staff, to accompany the ISA for LCE, the following information is given to explain how the IAASB has ensured that an audit under the ISA for LCE provides reasonable assurance while being both scalable and proportionate:

"Description of Key Principles to Address Identified Key Public Interest Matters

Qualitative standard-setting characteristics: The overall outcome of reasonable assurance and the Authority of the standard encapsulate completeness in reflecting the results of the broad information-gathering, outreach and consultations that informed the project and consistency with the priorities established to undertake the project based on the assessment of public interest and stakeholder needs. In addition, the scope of the standard is designed to support the scalability and proportionality of the ISA for LCE by clearly describing the typical nature and circumstances of an LCE."¹⁹

It is important to note that if the ISA for LCE was adopted in the UK, audit firms would still be required to comply with the same ethical and quality management standards as they do for audits under the suite of 36 ISAs (UK).

The FRC's *Ethical Standard*, the two quality management standards and ISAs (UK) are necessarily onerous given how essential trust in financial information is to trust in the capital markets.

¹⁸ [ISA for LCE landing page](#).

¹⁹ *Basis for Conclusions* prepared by the staff of the IAASB (December 2023) - International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE), including conforming amendments to other International Standards (page 8).

Returning to the development of ISAs (UK), a project, known as the 'clarity project', was commenced by the IAASB in 2004, with the aim of revising ISAs to make them more understandable and thus contribute to more consistent practice. ISAs were rewritten so that all requirements were denoted by the use of the word 'shall'. In addition to redrafting 19 standards, 16 standards also included new requirements, and a new ISA was issued - ISA 265 *Communicating deficiencies in internal control to those charged with governance and management*.

Examples of key areas where new requirements were introduced are as follows:

- Materiality in planning and performing an audit and its use in evaluating misstatements.
- Risk assessment and the gathering and evaluation of audit evidence.
- The audit of accounting estimates and related disclosures.
- Audit evidence in relation to external confirmations and written representations.
- Communication with those charged with governance.

Clarified standards were adopted for accounting periods ending on or after 15 December 2010.

The FRC adds additional material, known as 'pluses', to tailor ISAs to the UK. Some tailoring is necessary to comply with UK law and regulations, but other material is added where the FRC has decided to strengthen the requirements beyond those set by the IAASB.

For example:

- ISA (UK) 570 *Going concern* was strengthened in 2019, in response to concerns that additional audit work in this area needed to be undertaken as a matter of routine. Since the introduction of a revised ISA (UK) 570, charity trustees will have become familiar with the auditor making more detailed inquiries and asking for more robust evidence of their charity's going concern status.
- ISA (UK) 240 *The auditor's responsibilities relating to fraud in auditing financial statements* was strengthened in 2021 to address concerns raised by Sir Donald Brydon in his review of the quality and effectiveness of audit in the UK. The revisions were designed to provide increased clarity as to the auditor's obligations in relation to fraud risk. The revisions include enhancements to the requirements for the identification and assessment of risk of material misstatement due to fraud and the procedures to respond to those risks. Furthermore, the IAASB is currently consulting on further revisions to ISA 240 which might make the UK standard even more rigorous.
- ISA (UK) 250 *Consideration of laws and regulations in the audit of financial statements* is being revised by the FRC, following public consultation. The proposed changes strengthen auditor requirements to detect and report material misstatements arising from non-compliance with laws and regulations and seek to clarify the circumstances in which auditors should report such breaches, and other significant matters, to the relevant regulators. The FRC's intention is that this will enhance the useability and informativeness of the audit and provide greater assurance to users of financial statements that potential material misstatements have been properly assessed by the auditor. ICAS and other stakeholders have expressed concerns about these proposals, although we note that OSCR's response to the consultation is broadly supportive. Our concerns include the absence of specific reasons as to why the changes are considered necessary, and the extent of the audit work which in practice would need to be undertaken to meet the new requirements.

Also, since the clarity project was completed, the FRC has continued to revise and strengthen auditing standards following revisions made by the IAASB, including the following two key standards adopted in the UK:

- ISA (UK) 315 *Identifying and assessing risks of material misstatement* (for the audit of accounting periods beginning on or after 15 December 2021). The revisions were designed to establish more robust and consistent risk identification and assessment.
- ISA (UK) 540 *The audit of accounting estimates and related disclosures* (for the audit of accounting periods beginning on or after 15 December 2019). Revisions included: an enhanced

risk assessment requiring auditors to consider complexity, subjectivity and other inherent risk factors in addition to estimation uncertainty; a closer link between the enhanced risk assessment and the methods, data and assumptions used in making accounting estimates; and emphasis on the importance of applying appropriate professional scepticism when auditing accounting estimates to foster a more independent and challenging sceptical mindset in auditors.

Scottish charity and company audit thresholds

Traditionally, the Scottish charity audit threshold has been lower than the company audit threshold, but the differential has increased significantly since the 2006 accounting regulations were implemented for Scottish charities. This is set to continue.

Increases in the company law audit threshold has led to a decrease over time in the number of firms registered to undertake audit work. We expect this downward trend to continue with any future increases in the company audit threshold.

The reduction in the number of audit firms and the threshold differential are contributing to the challenges charities face in finding an auditor when they move from independent examination to audit, when they would like to change auditor, or when their auditor resigns from the engagement.

We provide further information on the downward trend in registered audit firms in the next section of our paper.

DBT announced, before the General Election, that it intended to increase the company size thresholds by 50% via amendment regulations. DBT's impact assessment for the proposed Companies (Non-financial Reporting) (Amendment) Regulations 2024 suggested that the small company size criteria and audit threshold are to remain coupled.

The proposed implementation date for these regulations was 1 October 2024. But following the change in government further clarification about any change in the audit threshold is awaited from DBT.

Since 1 October 2012, the company audit threshold has been coupled with the company law definition of a small company.

The following table sets out past, present and possible future company audit thresholds (size criteria):

Periods commencing on or after:	31 Jan 2004*	1 October 2012	1 Jan 2016	1 Oct 2024^
2 out of 3 of:				
Annual turnover	Not more than 6.5m	Not more than 6.5m	Not more than £10.2m	Not more than £15m
Balance sheet total	Not more than 3.26m	Not more than 3.26m	Not more than £5.1m	Not more than £7.5m
Average no. of employees	N/A	Not more than 50	Not more than 50	Not more than 50
*Prior to 1 October 2012 the audit threshold and the small company definition were not coupled. In order to elect for audit exemption before this date a company had to meet both the annual turnover and balance sheet criterion, in addition it would also have to be a small company. The small company definition also referenced an average no. of employees of not more than 50. ^Originally anticipated increase in the company audit threshold but further clarification is awaited following the General Election in July 2024.				

Companies also have a year's grace when exceeding the size criteria for an audit so that a company which is not on a growth trajectory doesn't have to have an audit until the size criteria are breached for two consecutive years. This additional concession is absent from the Scottish charity law threshold.

Charities registered with the CCEW that exceed the size criteria for an audit under English charity law can apply to the CCEW for dispensation from audit under regulation 34 of The Charities (Accounts and Reports) Regulations 2008. No similar provision is available under Scottish charity law.

We have included two case studies in this paper to illustrate the challenges charities experience due to the absence of a year's grace (or the option of applying for dispensation).

For comparison with the company audit threshold, the Scottish charity audit threshold under the 2006 accounting regulations is set out on page 5 above.

As referenced earlier in our paper, the audit threshold has not been amended since the 2006 accounting regulations were implemented on 1 April 2006, except for the aggregate value of assets which increased from £2.8 million for accounting periods beginning on or after 1 April 2011. It is worth noting that £2.8 million had been the assets criterion of the company law audit threshold at an earlier time, and that this criterion was revised upwards to £3.26 million. This means that the Scottish charity law assets criterion aligned with the company law criterion for a period of time. While the focus of our evidence has been the gross income criterion of the Scottish charity law audit threshold, we also believe that there is scope to consider an increase in the assets criterion.

The decline in the number of registered audit firms in the UK and the Republic of Ireland

There is a long-term downward trend in the number of firms in the UK and the Republic of Ireland (ROI) registered to undertake audit work and this is having an impact on the availability of audit services to Scottish charities. Information on the number of audit firms is gathered from each Recognised Supervisory Body and is not further analysed geographically.

The FRC produces a paper each year on *Key facts and trends in the accountancy profession*²⁰. A high-level analysis of these papers highlights that:

- Between 31 December 2001 and 31 December 2022, ICAS registered audit firms fell from 482 to 128 or 73%.
- In comparison, UK wide and ROI audit registered firms, in total, fell from 11,172 to 4,310 in the same period: a fall of 61%.

The most recent edition of *Key facts and trends in the accountancy profession* (August 2023) states "The number of audit firms registered to carry out statutory audit work in the UK and the ROI continues to fall. The number of registered audit firms fell by 5.2% in 2021 (to 4,745) and 9.2% in 2022 (to 4,310)."

N.B.:

- The four accountancy bodies registering audit firms reported on by the FRC are ACCA, CAI, ICAEW and ICAS. These are the Recognised Supervisory Bodies in the UK and the ROI.
- Statistics are not published separately on the number of audit firms operating in England, Northern Ireland, Scotland and Wales.
- Merger and acquisition activity has contributed to the fall in the number of audit registered firms between 2001 and 2022. This means that there is not a 100% correlation between the reduction in the number of registered firms and a fall in audit capacity. Nevertheless, the fall in the number of firms is evidence of a long-standing and continuing trend.

DBT's impact assessment for the latest proposed increase in the company size criteria and audit threshold has the potential to impact on the number of audit registered firms, as an estimated 8,000 companies currently classed as medium-sized would become small companies with the ability to elect for audit exemption.

²⁰ *Key facts and trends in the accountancy profession* publications are available on the FRC's website

Recent experience of members of the ICAS Charities Panel

Members of the Panel have recent experience of challenges faced by charities around audit services.

We remain of the view that the challenges are significant, and this reflects experience not just in Scotland but also in England and Wales, where ICAEW has recently [called for the charity audit threshold of gross income of £1m to be increased urgently](#).

Between December 2021 and December 2023, according to OSCR's sector overview the number of Scottish charities with an income of over £500,000 increased from 1,504²¹ to 1,636²², an increase of 132 charities or 8.8%. This would indicate that the number of charities requiring an audit must also have increased, suggesting that not adjusting the thresholds over the years for the impact of inflation means that an increasing number of charities require an audit. We understand that the proportion of charities requiring an audit has been relatively consistent since 2006 but viewing the data from this perspective does not address the impact of inflation on the level of sophistication of charities being caught by the audit threshold and the burden of audit on relatively less sophisticated organisations.

Charities do not change auditor each year. If charities retendered their external audits every five years, on average, based on 2023 numbers, only 327 charities would go through a tender process in any given year. Change that to every ten years and the number would be 164. So even a relatively small number of late accounts being filed due to not being able to find an auditor could be an indication that supply is not meeting demand.

From the experience of ICAS Charities Panel members who have trustee or FD roles, tender exercises are not proving successful, sometimes with only the incumbent auditor making a submission. This deprives the charity of the opportunity to change auditor. There are risks associated with limited or no competition, including risks to audit quality and the risk of increased audit fees. Increases in audit fees and a lack of added value are concerns raised by members of the Charities Panel in non-audit roles.

From an auditor perspective:

- Audit firms are planning charity audits at least a year ahead if not more. This means that unless a charity issues an invitation to tender a year or more in advance of seeking to change their auditor, audit firms are not in a position to submit a proposal. This is borne out by the experience of Charities Panel members involved with charities who are seeking an auditor.
- Charities considering changing their auditor sometimes contact audit firms to make initial inquiries. However, this does not always lead to the charity conducting a tender exercise, indicating that the trustees are not confident that such an exercise would be successful.
- Charity accounts are being filed closer to the filing deadline than in the past. This is an observation that could be more widely reflected across the sector. If there is a trend in later filing by Scottish charities this could also be an indication that audits are more challenging to complete, increasing the possibility that late filings could become more common.

Case studies

We have received inquiries from charities over a period of 18 months to two years where auditor availability has been a concern. We normally receive inquiries from charities when they have no incumbent auditor and need to find one at short notice. We also receive queries from accountancy firms, and these usually focus on the technicalities of the particular scenario.

We have written up two case studies based on queries we have received from accountancy firms this year. The main challenge in both case studies is the design of the audit threshold i.e. the absence of a year's grace from a one-off breach in the size criteria for audit following the unexpected receipt of legacy income.

²¹ *An Overview of the Scottish Charity Sector 2021* – Number of charities on the Scottish Charity Register

²² *OSCR Sector Overview report* (end of quarter 4 of 2023) – Income breakdown by numbers on the register (page 11)

Case study one

A charity received legacy income and did not recognise it in the correct financial year. It received an independent examination in that year, but had it recognised the income correctly it would have needed an audit. The following year, the independent examiner became aware of the legacy income. Therefore, under FRS 102, a prior period adjustment is required to correct a material error. By restating the previous year's accounts, the charity's income for the current year remained below the audit threshold.

However, as parliament's intention was that the charity should have received an audit, ICAS recommended that if the charity did not receive an audit of the current year's accounts, it should consider seeking legal advice before proceeding with an independent examination. The accounts are likely to be filed late due to the continuing uncertainty over the type of external scrutiny required. The firm undertaking the independent examination isn't audit registered so the delay in filing the accounts could be significant, as the charity seeks to appoint another firm to undertake the audit.

A year's grace from a one-off breach of the threshold would have been beneficial to the charity in this scenario i.e. if the Scottish charity audit threshold had been structured in a similar way to the company audit threshold, this would have enabled the charity to continue with an independent examination and to file its accounts on time.

Case study two

An audit firm has been in the position of being able to take on new charity audit clients. These are Scottish charitable companies which need an audit due to receiving legacy income late in the reporting period and therefore have had to find an auditor at short notice.

In each case the accounts preparation process was well advanced with another firm or firms before the charities realised that they had exceeded the audit threshold. In each case it has not been possible to complete the audit work in time to meet both the charity and company filing deadlines (both being nine months after the end of the reporting period). It is not clear whether any of the charities applied to Companies House for a filing extension before the filing deadline. But while some leeway seems to have been available, this was insufficient as revised timelines offered by Companies House could not be met.

Trustees have been receiving letters to their home addresses from Companies House. Two examples have been shared. One example advised the charity that there could be no further extension to the filing deadline and that the accounts should be filed, or the directors should take steps to strike the charitable company from the register.

The second example stated:

"Unless you can deliver the documents, in the correct form, within 28 days of the date of this letter, the Procurator Fiscal may take legal proceedings against you. A summons could be issued without further warning letters being sent to you, and the charges will include any other documents which become overdue after the date of this letter. If convicted, you will acquire a criminal record and could be fined up to £5,000 for each offence i.e. each document not delivered on time. You could also be disqualified from acting as a director of any company for up to 5 years if the Court considers this appropriate in your case."

The letter also highlights the financial penalties placed on companies for late filing.

Some trustees have resigned as a result of receiving these letters which is a risk to a charity's continuing operation in itself.

Like the first case study, a year's grace could have prevented the charitable companies breaching the audit threshold in a single year. Where charities which are also companies are impacted, the consequences of late filing for the trustees, who are the directors under company law, and the charities themselves are more serious than for non-company charities.



CA House, 21 Haymarket Yards, Edinburgh, UK, EH12 5BH
+44 (0) 131 347 0100
connect@icas.com
icas.com

 @ICASaccounting

 ICAS – The Professional Body of CAS

 ICAS_accounting

 ICAS_accounting