Charity audit and independent examination

RESPONSE FROM ICAS TO THE CABINET OFFICE

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Introduction

The ICAS Charities Committee welcomes the opportunity to comment on the Cabinet Office proposals on charity audit and independent examination for charities in England and Wales.

Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public and charity sectors.

Our Charter requires ICAS committees to act primarily in the public interest and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key points

The ICAS Charities Committee has within its membership charity finance directors, charity trustees, charity auditors and independent examiners. The views of the Committee are unanimous with regard to increases in both the charity audit and group accounts' preparation thresholds.

We do not agree with the proposal to increase the audit threshold and group accounts preparation threshold for charities in England and Wales for the following main reasons:

- The Cabinet Office has not provided sufficient evidence to support the threshold increases and the impact assessment accompanying the consultation is too simplistic in its consideration of anticipated savings.
- Charities are major providers of public services and therefore plans to increase the audit threshold seem out of step with the proposed reduction in external scrutiny requirements. An increase in the audit threshold would provide less comfort to government and the Charity Commission about the quality of governance and the financial health of the charity sector more generally. From the perspective of the general public, we believe that the proposed increase in the audit threshold would weaken the accountability of those charities which would no longer require an audit to this important stakeholder group.
- There is no requirement for an independent examiner to identify a charity's internal controls and to test their effectiveness while an auditor must do so. We believe that increasing the audit threshold has the potential to increase the risk to charitable assets from poor governance and fraud.
- Trustees may seek the additional comfort that an audit brings, especially if the charity doesn't employ a qualified accountant or there is a skills gap in relation to finance and accountancy on the trustee board. It is also possible that funders or lenders will make an audit a condition of funding or lending. Therefore, the scope for cash savings due to an increase in the audit threshold may be less than anticipated.

- Group structures introduce additional risk to a charity's business model and we believe it is important that group accounts continue to be prepared and audited at the level of the current threshold so that a charity's trustees have clear sight of the group's financial position and performance. We also believe that the publication of audited group accounts for charitable groups, with income of more than £500,000, affords an appropriate level of accountability to other stakeholders which would be lost through threshold increases.

The new EU Accounting Directive is due to be implemented in the UK from 1 January 2016. The Directive scopes out charitable bodies but it will nevertheless impact on charities through its wider impact on the UK's financial reporting regime for small entities. The Financial Reporting Council plans to withdraw the Financial Reporting Standard for Smaller Entities (FRSSE) and as a result charities which meet the revised definition of small, which will be most charities preparing true and fair accounts, are expected to fall within the scope of a new small entities' regime under FRS 102. It is possible that these changes can be implemented for charities without regulation. However, we recommend that the Cabinet Office works with the Charity Commission and the Office of the Scottish Charity Regulator, as the joint SORP-making body, to ensure that any and all changes arising from this consultation and the implementation of the Directive are presented to the charity sector as a single package of reforms. Such an approach would undoubtedly reduce the regulatory impact on the sector.

Our responses to the consultation questions are included in the Appendix.

Any enquiries should be addressed to Christine Scott, Assistant Director, Charities and Pensions, at cscott@icas.org.uk.

Appendix

Responses to consultation questions

Raising the financial audit thresholds

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?

Answer 1
We do not support the proposed increase in the audit threshold, including the increase in the income condition, and we believe that the current threshold is about right. While we acknowledge the wide disparity between the level of the charity audit threshold and that which applies to private companies, we believe there are good reasons for this which we touch on in our responses to questions 4 and 7.

We believe that the Cabinet Office has not provided sufficient evidence to support the increase in the audit threshold and that the impact assessment is too simplistic. There has been no assessment of the potential risks or costs of removing the audit requirement for what are substantial charities and there has been no consideration of the benefits of an audit in comparison to those of an independent examination.

Charities are major providers of public services and therefore plans to increase the audit threshold seem out of step with the proposed reduction in external scrutiny requirements. An increase in the audit threshold would provide less comfort to government about the quality of governance and the financial health of the charity sector more generally. From the perspective of the general public, we believe that the proposed increase in the audit threshold would weaken the accountability of those charities which would no longer require an audit to this important stakeholder group.

According to NCVO's Civil Society Almanac 2014, voluntary sector income in 2011/12 was £39.2 billion (2010/11: £39.9 billion) including income from statutory sources of £13.7 billion (2010/11: £15 billion) or 35% (2010/11: 38%). These figures highlight that government is a major stakeholder in the sector and with sector income, including from income statutory sources, being squeezed, we do not believe this is an appropriate point to reduce the level of sector scrutiny.

There is no requirement for an independent examiner to identify a charity's internal controls and to test their effectiveness while an auditor must do so. We believe that increasing the audit threshold has the potential to increase the risk to the charitable assets from poor governance and fraud.

Charities with income of £500,000 to £1,000,000 are likely to be complex organisations which have more of the following features than charities with an income of less than £500,000: employ staff; hold property and investments; carry a pension deficit, hold numerous restricted funds and receive public money through grants and contracts; have trading operations and a group structure. We believe that this degree of complexity lends itself to an audit rather than an independent examination.

The absence of an audit could lead to trustees choosing to or having to engage finance professionals in an advisory role to prepare the charity's accounts, to examine how grants monies have been spent or to undertake a full audit. Market forces could therefore reduce the cost savings anticipated by the impact assessment.

Trustees very often value the audit process and may continue to seek the additional comfort an audit brings especially if the charity doesn't employ a qualified accountant or there is a skills gap in relation to finance and accountancy on the trustee board. It is also possible that funders or lenders will make an audit a condition of funding or lending.

Some funders, such as the EU, insist that evidence that specific grants have been spent as intended is supported by an auditor's statement. This means that as things stand, some charities which only require an independent examination, have to appoint an auditor to examine and report on grant expenditure. For charities in this position, an auditor would likely need to undertake additional work, relative to an auditor appointed to undertake a full statutory audit, as the audit team would not have the same degree of knowledge of the client. It is likely that the number of charities in this position would increase if the audit threshold increased and this could be an influencing factor in deciding whether to continue with an audit on a voluntary basis.

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?

Answer 2
We do not support the proposal to increase the threshold for the audit or the preparation of group accounts. We believe the audit and accounts preparation thresholds for group accounts are about right and that the thresholds should continue to be aligned with the income condition for the existing audit threshold.

Group structures introduce additional risk to a charity's business model and we believe it is important that group accounts continue to be prepared and audited at their current level so that the trustees have clear sight of the group's financial position and performance. We also believe that the publication of audited group accounts for charitable groups, with income of more than £500,000, affords an appropriate level of accountability to other stakeholders which would be lost through threshold increases.

An auditor is in a better position than an independent examiner to ensure that the components of the group are identified and properly included in the group accounts.

We make additional comments about the group accounts' preparation threshold in our response to question 7.

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

Answer 3
No, we believe that the income component of the asset condition should not be increased. We set out our reasons for this in our response to question 4.

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)?

Answer 4
We would support a position of no increase in the asset condition even if this means that the charity law asset condition comes to differ from the company law asset condition.

The rationale behind having a lower audit threshold for charities than for companies includes ensuring the protection of charitable funds therefore the asset condition is an important one. In these days of low returns on investment, it is not inconceivable that a charity might be custodian of £30,000,000 of charitable funds without having £1,000,000 of gross income per annum.

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

Answer 5
Yes. As referred to in our response to question 1, we do not believe sufficient evidence has been gathered to support an increase in the audit threshold and increasing the audit threshold could have negative unintended consequences which have not been taken into account in the impact assessment. For example, we believe that increasing the audit threshold has the potential to increase the risk to the charitable assets from poor governance and fraud.

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.

Answer 6
We have no specific comments to make on the estimated costs and estimated savings outlined in Part IV. However, we set out our views in our response to question 1 on how increasing the audit threshold could impact on behaviour, meaning that the impact assessment is too simplistic.

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

Answer 7
We believe that there is scope to amend the structure of the charity audit threshold which would prevent charities which receive a one off boost to their income falling into and then out of the audit regime.

Under company law, the audit threshold is currently aligned with the definition of a small company. We believe there is some merit in applying the structure of the company law audit threshold (although not the threshold conditions themselves) to the charity law audit threshold. This could be achieved by using the qualifying conditions applied in the Companies Act 2006 through:

- introducing the number of staff (employees) as a condition;
- requiring two out of three conditions (income, assets and staff numbers) to be met before an audit is required; and
- permitting a charity to continue to be exempt from audit if it fails to meet two out of the three conditions in a single year.

If this approach was followed, the charity accounting regulations should also be mindful of the approach taken in company law towards the position of a company in its first year.

We do not believe that increases in the company law audit threshold should necessarily influence increases in the charity audit threshold. (Notwithstanding that we believe the structure of the company law audit threshold has features which would also be appropriate for a charity audit threshold.)

The relationship between a company and its shareholders is not the same as the relationship between a charity and its stakeholders. A company's shareholders are often its directors and managers and where shareholders are at arm's length additional governance arrangements are implemented to protect their interests, for example, listed companies must comply with the Listing Rules. The Listing Rules require a company to either comply with the provisions of the UK Corporate Governance Code, issued by the Financial Reporting Council or explain to investors in their next annual report why they have not done so.

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?

Answer 8
We believe that the group accounts' threshold should be aligned with the audit threshold and we do not agree with the proposed increase in either the audit threshold or group accounts' threshold.

We also believe that that it would be helpful to permit charities to assess whether group accounts are required on a gross or a net basis rather than just a net basis. This would:

- be consistent with the approach taken in the Companies Act 2006; and
- would enable charities to assess whether group accounts are required without having to undertake a consolidation exercise to achieve this.

This would involve introducing a slightly higher figure for the gross basis to accommodate inter-company transactions. Allowing the gross basis as an option would mean a reduction in unnecessary red tape as charities would not have to undertake a consolidation exercise just to check whether or not group accounts were required.

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?

Answer 9
There are no additional bodies we wish to propose to be added to the list of whose members could carry out independent examinations of charities with an income of 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.

Answer 10
Not applicable.