

# CHARITIES AND SELF-REGULATION: THEORY AND PRACTICE IN THE ROLE OF INDEPENDENT EXAMINERS UNDER S43(3) OF THE CHARITIES ACT 1993

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## 1 Introduction

Much of the modern framework for regulation of charities in England and Wales first emerged with the Charities Act 1992. Many of the current powers of the Charity Commission have only existed since then. But charity regulation is not just a matter for the Commission: the 1992 Act also introduced other regulatory roles. In particular, for the first time it assigned specific reporting duties to charity auditors, and for charities not large enough to require a full audit, a new regime of *independent examination* was created.

Independent examiners do not necessarily have to be accountants, and will frequently be individuals with a background in the charity sector (see further below). However, only a small proportion of smaller charities will ever be subject to detailed scrutiny by the Charity Commission: for most, the review of their accounts by an independent

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The field research in this study was supported by the Council of the Association of Charity Independent Examiners. Extensive assistance with initial searches and tabulation of fieldwork results was given by Sharon Morgan. The subsidised training for voluntary independent examiners was made possible by grants to ACIE from the Lloyds TSB Foundation for England and Wales. Other aspects of this work were supported by Sheffield Hallam University Faculty of Organisation and Management.

examiner is the most intensive regulatory scrutiny they will receive.

Hence, it is argued, the work of independent examiners provides a form of statutory *self-regulation* whereby individuals from within the sector oversee the accounts of other charities. Those acting as independent examiners are, in practice, exercising a major regulatory role in ensuring that charitable organisations comply with a range of legal requirements and the former Chief Charity Commissioner has described independent examiners as “invaluable allies” in the Commission’s task of improving the transparency and accountability of charities<sup>2</sup>. But the fact that these individuals can be drawn from roles within other charities and do not generally have to be professional accountants, means that, in practice, this is an area where legal requirements can effectively be satisfied through the charity sector regulating itself.

This paper explores the nature of independent examination regime, both from the perspective of the legal framework under which independent examiners operate, and from some fieldwork drawing on a substantial sample of charity accounts, to consider the operation of the regime in practice.

## 2 The Framework

Charities have been required to publish accounts since the Charities Act 1960, but compliance was very variable<sup>3</sup> and it is only since the Charities Act 1992 that any detailed legislation existed to prescribe the form and content of charity accounts, and the extent to which the accounts were to be subject to independent scrutiny.

The current requirements, contained in Part VI of the Charities Act 1993<sup>4</sup> as amended<sup>5</sup>, require all charities in England and Wales to publish accounts once a year and, except for the very smallest organisations under £10,000 income, to have those accounts scrutinised independently. It is common to describe this scrutiny as an “audit”, but the law reserves the term “audit” for a full professional audit by a firm of registered auditors, which is only required for charities over £250,000

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2 Stoker, John, 2004. *Address to the Annual Conference of the Association of Charity Independent Examiners* (London 18 May 2004, as quoted in *Independent Examiner* 6(2), Summer 2004, pp. 1 & 5).

3 Palmer, Paul & Randall, Adrian, 2002. *Financial Management in the Voluntary Sector: New Challenges* (London: Routledge).

4 The accounting provisions of the Charities Act 1992 were subsequently re-enacted in Part VI of the Charities Act 1993.

5 By the Deregulation and Contracting Out Act 1994, and by the Charities Act (Substitution of Sums) Order 1995 (SI 1995/2966).

income<sup>6</sup>. Charities in England and Wales<sup>7</sup> below this threshold which are not structured as companies<sup>8</sup> are allowed to opt for an *independent examination* of their accounts. So the legislation has created a regime for scrutiny of charity accounts with three levels<sup>9</sup> as illustrated in Table I.

TABLE I:

Minimum permitted scrutiny of accounts	Non-company charities <sup>10</sup> established in England & Wales: Income / expenditure level
Approval of accounts by trustees only	£0 to £10,000
Independent Examination	£10,000 to £250,000
Full Audit	Over £250,000

6 The new Charities Bill in the House of Lords in 2005 (clause 27) proposes to increase the upper limit for independent examination to £500,000 income, subject to conditions which are discussed later in this paper.

7 The requirements for charity accounting vary between the different jurisdictions of the United Kingdom. Although the concept of independent examination of a charity's accounts is also permitted under Scottish charity law there are some significant differences in the examiner's reporting duties and in the relevant income thresholds.. The current Scottish rules are contained in the Charities Accounts (Scotland) Regulations 1992 (SI 1992/2165) made under s5(5)(c) of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990, though these are due to be replaced by new regulations under s44(4)(g) of the Charities and Trustee Investment (Scotland) Act 2005. There is no current legislation on the form of charity accounts in Northern Ireland, although a consultation paper on proposals for reform was launched in February 2005 by the Charities Branch of the Northern Ireland Department for Social Development ([www.dsdni.gov.uk/consultation-zone/Document.asp?ID=49](http://www.dsdni.gov.uk/consultation-zone/Document.asp?ID=49)).

8 Different rules apply to charities which are legally structured as companies, as the scrutiny of their accounts then takes place under the Companies Act 1985 (special provision for companies which are charities). The discussion in this paper is thus restricted to non-company charities in England and Wales (see note 10 below).

9 Charities Act 2003 s43, as amended.

10 Most writing on charity accounting uses the term "unincorporated" to refer to charities which are not companies (trusts, associations, and others). However, this is potentially misleading, because there are some incorporated legal structures used by charities *other* than those permitted under the Companies Act - for example Parochial Church Councils (PCCs) in the Church of England, or charities where the body of trustees has been incorporated under the provisions of s50 of the Charities Act 1993. Also, the new Charities Bill will create a new legal form of Charitable Incorporated Organisation (CIO), but CIOs will be subject to the same accounting rules as non-company charities. It is only the charitable companies which are excluded from independent examination: charities such as PCCs (at present) and CIOs (in future) fall within the regime.

This paper is an exploration of the operation of the independent examination regime - the middle level in the table above.

The law defines an independent examiner (IE) as:

*“an independent person who is reasonably believed by the charity trustees to have the requisite ability and practical experience to carry out a competent examination of the accounts<sup>11</sup>”.*

A wide range of people can thus potentially act as IEs. Some are professional accountants but many are people who would be seen as coming from "within" the third sector: for example, a treasurer or finance officer of one charity may well act as independent examiner to another organisation; independent examinations undertaken on this basis are often voluntary. Some IEs are employed by community accounting projects operated by voluntary organisations to support other such organisations<sup>12</sup>. Other IEs are specialist consultants working with voluntary organisations, who are heavily involved in a cross section of voluntary sector issues.

However, in order to carry out an independent examination, the person chosen as IE must follow a regime which is laid down in some detail by statute and regulation - it is much more than an informal checking of the books.

The next section of the paper presents a review of the statutory framework for independent examination in terms of how it developed, the differences between independent examination and audit, and the application of the regime. We then explain the methodology for the present study, followed by finding and conclusions.

### **3 The Independent Examination Regime**

#### *3.1 The Development of the Statutory Framework*

In the 1980s, only a minority of charities actually filed any accounts with the Charity Commission. It became clear that if donors and public sector funders were to have confidence in the accounts of the charities they supported, major changes would be needed to the entire mechanisms for supervision of charities. The early history of these developments is reported by Ray Jones<sup>13</sup>.

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<sup>11</sup> Charities Act 1993 s43(3).

<sup>12</sup> Community Accountancy National Network website ([www.communityaccountancynetwork.org.uk](http://www.communityaccountancynetwork.org.uk) Dec 2004).

<sup>13</sup> Jones, Ray, 2002. *The Role and Development of Independent Examination* (Paper presented at the Association of Charity Independent Examiners Annual Conference, London, May 2002. A summarised version appears in *Independent Examiner* 4(2), p2).

To address these concerns, the Government established a commission under Sir Philip Woodfield to consider the best way forward. The Woodfield report<sup>14</sup> accepted that it would be prohibitively expensive to require even very small charities to have a full professional audit. However, all charities are holding funds entrusted to them, and even at the smallest level some standards were felt to be needed. Woodfield thus proposed a graduated regime with increasing requirements for financial reporting and scrutiny depending on a charity's income or assets. Woodfield proposed a reduced scrutiny regime (which he called "independent audit", but which subsequently became "independent examination") for the accounts of charities up to £10,000 income.

The proposals were considered further in the Government's 1989 White Paper<sup>15</sup> which accepted that smaller charities might have their accounts "independently examined" subject to detailed guidelines on the examination process, although the White Paper suggested that independent examination might be permitted for charities up to £50,000 income.

The new proposals became law in the Charities Act 1992 (later consolidated into the Charities Act 1993) creating in England and Wales, for the first time, a statutory regime for scrutiny of accounts of unincorporated charities. Initially the Act required a charity to have an audit if its income or expenditure exceeded £100,000, with the option of independent examination below this.

Following a Government taskforce on deregulation of the sector<sup>16</sup>, the thresholds in the 1993 Act were amended as noted above to allow independent examination to apply for charities up to £250,000 income, and at the same time a "light touch" regime was created for charities below £10,000 income where the accounts could be approved purely by the trustees without any external scrutiny<sup>17</sup>.

It is anticipated that the threshold will increase further still: the major review of charity and voluntary sector law *Private Action: Public Benefit* proposed allowing

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14 Woodfield, Sir Philip, 1987. *Efficiency Scrutiny of the Supervision of Charities* (London: HMSO).

15 Home Secretary, 1989. *Charities: A Framework for the Future* (London: HMSO Cmd 694).

16 Baring, T (ed) 1994. *Charities and Voluntary Organisations Task Force Proposals for Reform: Volume 1: Summary Document (p9-10) & Volume 2: Full Report (p9)* (London: Government Deregulation Task Force, July 1994).

17 Morgan, Gareth G, 1999. *The Changing Face of the Charity Treasurer and Bookkeeper: Assessing the Impact of the Charities Act 1993* in *Charity Law & Practice Review*, 6(2), pp89-114.

independent examination of charity accounts up to £1M income<sup>18</sup>. Detailed review of this led to the Government taking a slightly a slightly more cautious approach with a £500,000 upper income limit<sup>19</sup>. This is now included in clause 27 of the new Charities Bill before Parliament<sup>20</sup>. However, in the band of charities from £250,000 to £500,000 income, the independent examiner will be required to have a recognised professional qualification<sup>21</sup>. This will effectively create a fourth band in the scrutiny requirements.

But the current position, on which the present research is based, is as shown in Table I: we are concerned with the accounts of non-company charities with incomes in the range £10,000 to £250,000. Within this band are two quite different systems of accounts presentation<sup>22 23</sup>: up to £100,000 income, charities are allowed<sup>24</sup> to prepare receipts and payments accounts, but for those in the £100,000 to £250,000 band, accruals accounts on a true and fair basis are required, presented in accordance with

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18 *Private Action, Public Benefit: A Review of Charities and the Wider Not-for-Profit Sector* (London: Cabinet Office Strategy Unit, September 2002).

19 *Charities and Not-for-Profits: A Modern Legal Framework - The Government's Response to 'Private Action: Public Benefit'* (London: The Home Office July 2003).

20 See note 6 above.

21 In the Bill as initially introduced the permissible qualifications included members of the six chartered accountancy bodies and of other bodies whose members are eligible to be reporting accountants under company law. But the revised Bill introduced following the 2005 Generally Election significantly also now includes Fellows of the Association of Charity Independent Examiners (ACIE) thus allowing a wider range of people from within the sector to act as IEs, if they can satisfy the criteria for Full Membership of ACIE at the highest level – the role of ACIE is considered in more detail later in this paper. The report of the Parliamentary Scrutiny reviewing the Draft Bill was sympathetic to this (Milburn, Alan [Chair], *House of Lords, House of Commons Joint Committee on the Draft Charities Bill* Report issued 30 September 2004 3 vols HL Paper 167-I, HC 660-I Norwich: TSO). When the Bill was formally introduced (in the first version, prior to the 2005 election), peers tabled amendments specifically to add ACIE members (House of Lords Hansard 14 March 2005 Col GC461). The latest provisions are contained in clause 27(5) of the Bill which adds a new subsection 43(3A) to the 1993 Act. For further details of ACIE qualification levels see note 39 below.

22 Chitty, David & Morgan, Nick, 2001. *Charities: An Industry Accounting and Auditing Guide* 3rd edn (London: ABG Professional Information).

23 Morgan, Gareth G, 2002. *The Charity Treasurer's Handbook: An Introduction to Voluntary Sector Finance and Accounting* (London: Directory of Social Change).

24 Charities Act 1993 s42, as amended.

the Charities SORP<sup>25</sup>.

The independent examination regime applies to excepted charities<sup>26</sup> as well as to registered charities: thus many churches, scout and guide groups, armed forces charities, and similar organisations are able to take advantage of independent examination.

### 3.2 *Duties of Independent Examiners*

Whether a charity has an audit or independent examination, it must be undertaken *in accordance with the relevant regulations* which create many specific duties in the context of charity accounts.

Regulation 8 of the Charities (Accounts and Reports) Regulations 2005<sup>27</sup> contains seven paragraphs detailing the reporting duties of independent examiners, and regulation 9 gives independent examiners and auditors the same statutory rights of access to the charity's books and documents, and a right to require explanations from present and past trustees and officers of the charity.

Furthermore, the Charity Commission is empowered<sup>28</sup> to make directions (not just guidance) on the carrying out of an independent examination, which means that the Charity Commission is in effect given the power to make legislation in this area. The Commissioners have created a regime which contains twelve directions<sup>29</sup>. Key

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25 The requirements on the form and presentation of accounts are now governed by the Charities (Accounts and Reports) Regulations 2005 (SI 2005/272) made primarily under s42 of the Charities Act 1993. In a number of places the Regulations make reference to the principles set out in the Statement of Recommended Practice on Accounting and Reporting by Charities (“the SORP”) (Charity Commission, 2005).

26 Excepted charities are not required to be registered with the Charity Commission (Charities Act 1993 s3(5)), but are still subject to most of the other requirements of the Act including the accounting rules. The new Charities Bill will considerably reduce the category of “excepted charities”.

27 This analysis refers to the latest version of the regulations, but the same requirements were included in the Charities (Accounts and Reports) Regulations 1995, which were in force during the period of the fieldwork reported later in this paper.

28 Under s43(7)(b) of the Charities Act 1993.

29 *Independent Examination of Charity Accounts 2001: Directions and Guidance* (Charity Commission booklet CC63).

issues include:

- a direction that an independent examiner must obtain a proper understanding of the charity, including the governing document, methods of working, etc (it is not sufficient just to examine the books on a mechanical basis - an examiner must, for example, be able to judge whether there are material transactions that might represent a breach of trust);
- an examiner must consider whether the charity has maintained proper accounting records as required by s41 of the Charities Act 1993 (a view which can only be formed after a well-planned analytical review of the records that are provided);
- analytical procedures are required to identify unusual items or disclosures (though an examiner is not required to trace all transactions back to source documents unless concerns arise - the emphasis is on intelligent understanding of the accounts, rather than mechanical ticking-off of every transaction);
- a duty is given to report on any material inconsistency between the accounts and any financial comments in the annual report;
- an examiner must consider whether the accounts comply with the accounting regulations of the Charities Act 1993 (except that an examiner does not have to express a view on whether the “true and fair” requirement is met);
- in extreme cases, where an examiner believes that a trustee has been involved in "deliberate or reckless misconduct in the administration of the charity" an examiner has a whistleblowing duty, to inform the Charity Commissioners directly<sup>30</sup>.

### 3.3 *Independent Examination versus Audit*

Although independent examination represents a lesser form of scrutiny than a full audit, it is clear from the description above that it is much more demanding than the type of “informal audit” which many groups have had in the past. The two main differences between independent examination and audit relate to

- (a) who can act and
- (b) the nature of the report.

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<sup>30</sup> The implications of this are considered by Picarda, Hubert QC, 2001. *Independent Examination of Charity Accounts 2001* in *Charity Law & Practice Review* 7(2), pp93-108.

If an audit is required, the charity's trustees must appoint a registered auditor. However, an independent examiner can, in principle, be any person who satisfies the definition given in section 1 above, but guidance by Charity Commission<sup>31</sup> indicates the four issues of independence, requisite ability, practical experience, and willingness to undertake a competent examination in accordance with the rules must always be satisfied. For charities above £100,000 income the Commissioners recommend that the IE should be a “qualified accountant (or an individual with similar qualifications in charity finance at an appropriate level)” and in future for charities over £250,000 a qualification on these lines will be mandatory under the new Charities Bill. This means, as explained above, that many individuals within the voluntary sector can act as IEs - certainly for charities with up to £100,000 income, but also in many cases for larger charities.

However, the fieldwork reported below suggests that charities are not always appointing IEs who meet these criteria of ability and experience.

The other main distinction between independent examination and audit concerns the form of report. An IE does not express the “true and fair” opinion found in audit reports - rather, an IE's report provides a “negative assurance” in four key areas. To paraphrase the precise reporting duties, an unqualified independent examiner's report declares that *after carrying out all the required procedures*<sup>32</sup>:

- no evidence was found of lack of accounting records;
- nor of accounts failing to comply with the records;
- nor of accounts failing to comply with the Act;
- nor of other matters that need to be disclosed for a proper understanding of the accounts.

This negative assurance does make for difficulty in the wording of the examiner's

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31 The guidance is made under s43(7)(a) of the Charities Act 1993 and appears in CC63 (op cit), Appendix 1 (p19-20).

32 The required procedures are the directions under s43(7)(b) which are set down in CC63 (op cit).

report, and the Charity Commission examples generally need a full page<sup>33</sup>.

### 3.4 *Application of the Independent Examination Regime*

The vast majority of charities, by number, are small voluntary organisations, or grant-making trusts with modest financial resources. Of registered charities in England and Wales only 7% have incomes over £250,000 and thus require a statutory audit. 61% are very small charities with incomes below £10,000 with no statutory requirement for external scrutiny of their accounts<sup>34</sup>.

This leaves a very substantial band of charities with incomes in the £10,000 to £250,000 range, amounting to over 50,000 organisations or 32% of those on the register, where independent examination is likely to be possible. Extrapolating this to include excepted charities, Scottish charities, etc, it is likely that at least 80-90,000 UK charitable organisations fall into the independent examinations bands (some of these will be charitable companies, so not eligible for independent examination, but this only applies to a minority).

Research undertaken amongst members of the Association of Charity Independent Examiners<sup>35</sup> (ACIE) indicates that the average number of examinations per year undertaken by any one IE is four. It seems unlikely that this would be any higher for non-members of ACIE. With 80-90,000 UK charities requiring an independent examination, this suggests that at least 20,000 individuals are acting as IEs. This is a very substantial number within any measure of voluntary sector activity.

Occasionally a charity's trustees will want the assurance of an audit even if their income is below the required thresholds, or will have to have audits to satisfy their funders or governing documents. But for most charities, it is argued, the framework described above means that independent examination provides a very attractive regulatory option, going much further than the "informal audits" of the past, yet without needing a registered auditor. An independent examiner who carries out his or her duties effectively in accordance with the regulations is in fact undertaking a

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33 An independent examiner's reporting duties in England & Wales are detailed in reg 8 of the Charities (Accounts and Reports) Regulations 2005. In addition to the four areas above (which must *always* be covered in the examiner's report), an examiner must also report on three other issues if concerns arise, namely:

- material expenditure which appears to be outside the trusts of the charity;
- lack of satisfactory information or explanations;
- inconsistencies between the annual report and the annual accounts.

34 *Registered Charities - Facts & Figures* (www.charitycommission.gov.uk, Income of Registered Main Charities in England & Wales – quarterly figures March 2005).

35 Evidence Submitted by the Association of Charity Independent Examiners to the Joint Committee on the Draft Charities Bill (17 June 2004 - published at www.parliament.uk).

very comprehensive scrutiny.

The examiner's report must be circulated with all copies of the charity's accounts, and thus a qualified report raising concerns will be seen by funders, supporters and others with an interest in the charity: charity accounts are often read much more widely than those of businesses of a similar size. Once the implications of a qualified report<sup>36</sup> are understood, this creates a strong pressure in practice on charity trustees and officers to manage things in a way that will avoid such a qualification.

It follows that where a charity's accounts have been subject to independent examination, and the examiner has reported properly in accordance with the legislation, users of charity accounts can have considerable confidence in what is reported, and anecdotal evidence indicates that funders are increasingly accepting this.

### 3.5 *Support of Independent Examiners*

An Association of Charity Independent Examiners<sup>37</sup> was formed in 1999 to provide “support, training and professional qualifications” to independent examiners throughout the UK. ACIE is both a professional body, and a charity in its own right seeking to advance the effectiveness of other charities<sup>38</sup>. The Association provides a range of publications, training events and individual advice to support IEs.

The 2004 survey of ACIE members mentioned above indicated a wide cross section of people becoming involved in independent examining. At the time over 500 individuals were involved in the Association.

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<sup>36</sup> A “qualified wording” refers to an independent examination or audit report which is not totally “clean” - i.e. where the IE or auditor includes certain reservations or qualifications in the report on the charity's accounts.

<sup>37</sup> Further details of the Association are available from: Association of Charity Independent Examiners, Bentley Resource Centre, High Street, Bentley, Doncaster DN5 0AA, UK. Tel: 01302 828338. Website: [www.acie.org.uk](http://www.acie.org.uk). E-mail [info@acie.org.uk](mailto:info@acie.org.uk).

<sup>38</sup> ACIE membership leaflet January 2004. The author served as part-time ACIE General Secretary from 1999-2004, until permanent staff were appointed.

Sixty-five of these had achieved Full Membership of ACIE<sup>39</sup>, but of these only 34 (52%) also hold membership of one of the chartered accountancy bodies<sup>40</sup>. Those who have taken the trouble to obtain the *MACIE* qualification are likely to be amongst the most committed independent examiners, so it is significant that *even at this demanding level* it appears a wide range of non-accountants - mainly people with other roles within the voluntary sector - are willing not just to take on the duties of an independent examiner, but are willing to seek admission to a professional qualification in the field.

#### **4 Understanding the Role of Independent Examiners: Research Methods**

The statutory framework for accounting under the Charities Act 1993 took effect for accounting periods starting on or after 1st March 1996<sup>41</sup>. Allowing time for charities to complete an accounting year and prepare accounts, the first statutory independent examinations in England and Wales thus began from 1997 and 1998. Accordingly there is now a good six years experience of the regime, on which to conduct fieldwork.

In order to investigate whether the regime is proving effective, it is necessary to explore the operation of independent examination in practice. In particular, it is important to establish whether independent examination is an effective form of self-regulation within the voluntary sector (in the sense defined in section 1) or whether it is imposing excessive regulatory barriers to voluntary activity such as those reported by Rochester<sup>42</sup>.

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<sup>39</sup> Full Membership of ACIE, denoted *MACIE*, is a qualification requiring submission of detailed evidence of experience in charity accounting/independent examining (ACIE's Regulations for Full Membership appear in their Annual Handbook – see next note). The *MACIE* is intended to provide a means for IEs coming from within the sector to obtain a formal qualification, and for accountants in practice to demonstrate a specialisation with small charities. The qualification is offered at various levels, with members typically authorised to act as IEs to charities up to a specific income: those Full Members authorised at the maximum level are designated “Fellows” – this is the qualification which appears in clause 27(5) of the new Charities Bill (see note 21 above).

<sup>40</sup> *ACIE Annual Handbook and Directory 2004/05 Edition* (Doncaster: Association of Charity Independent Examiners).

<sup>41</sup> Charities (Accounts and Reports) Regulations 1995 Reg 1.

<sup>42</sup> Rochester, Colin, 2001. *Regulation: The Impact on Local Voluntary Action* in Harris, M & Rochester, C (eds) "Voluntary Organisations and Social Policy in Britain" (Basingstoke: Palgrave).

#### 4.1 *Previous Work*

Some initial research by the present author<sup>43 44</sup> sought to examine these issues using primarily qualitative methods drawing on

- (a) participant observation work with ACIE members,
- (b) a small scale study in the year 2000 of the accounts of 100 registered charities as filed with the Charity Commission; and
- (c) a questionnaire survey of over 90 persons training to be independent examiners through courses run by ACIE in 2001 or 2002 (including follow up 12 months later).

The insights from these studies served to provide significant themes for further investigation, but they were not necessarily conclusive. The studies of those involved in ACIE or taking part in ACIE training are not necessarily typical of the population of UK independent examiners as a whole.

The principle of studying accounts as filed with the Charity Commission offers a much more systematic approach, but the initial survey in 2000 found only 19 cases of independent examination out of the 100 charities initially considered, so it was difficult to draw generalisations from such a limited sample. Moreover, in 2000 most charities had not published more than one or two years of accounts subject to the requirements of the Charities Act 1993; knowledge and understanding of the regime was still relatively new. Although much publicity had been arranged by the Charity Commission, Home Office and umbrella bodies, it tended to concentrate on the accounting requirements such as the SORP<sup>45</sup>, rather than the requirements of audit and independent examination.

It was therefore felt that a much more substantial study of accounts filed at the Charity Commission should be conducted. By late 2003 the regime had been in

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<sup>43</sup> Morgan, Gareth G, 2002c. *Self-Regulation in the Voluntary Sector: An Investigation of Charity Independent Examiners* in Proceedings of the NVCO Researching the Voluntary Sector Conference, University of Nottingham, September 2002.

<sup>44</sup> Morgan, Gareth G. *A Statutory Regime for "Lay Audits": Assessing the First Five Years of Charity Independent Examiners* (British Accounting Association Annual Conference, Manchester, April 2003).

<sup>45</sup> *Statement of Recommended Practice on Accounting by Charities* (Charity Commission 1995) and *Statement of Recommended Practice on Accounting and Reporting by Charities* (Charity Commission 2000).

force for all charities for at least five years; this latest study also sought to record key variables from the accounts reviewed in a way that would permit systematic analysis.

#### 4.2 *The Present Charity Accounts Study*

The present study was planned as follows. It was decided to study in some detail at least 100 sets of recent charity accounts where the accounts were potentially eligible for independent examination. The aim was to assess (as far as could be determined from the published accounts) how effectively the independent examination regime was being applied.

To obtain a final sample of 100 charities meeting this criterion, 700 registered charity numbers were chosen initially<sup>46</sup>. For each of these 700 charities, the register of charities as available on the internet<sup>47</sup> was inspected to determine: whether the charity was active (as opposed to former charities which had been de-registered); the nature of its governing document (so that charitable companies could be eliminated); whether the charity had submitted returns to the Charity Commission within the last two years; and the total income of the charity (or total expenditure if larger) for the last year for which accounts had been submitted.

Only those charities which were *potentially eligible for a statutory independent examination of their accounts* were selected for further study - i.e. those charities which were active, were not companies and with income between £10,000 and £250,000<sup>48</sup>.

From the 700, initial eliminations included 216 charities (31%) which were inactive, either having been de-registered or, in a few cases, where the number was never used; and 64 charities (9%) which were charitable companies.

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<sup>46</sup> The 700 were selected in seven bands of 100. The registered charity number indicates the chronological point at which a charity was registered, and for early registrations, the Charity Commission office which dealt with it, but is not linked to any other aspect of the charity. To keep the sample as random as possible, the seven bands were chosen to include charities registered back in the 1960s up to charities registered in the late 1990s, and examples from each of the Commission's offices.

<sup>47</sup> At [www.charitycommission.gov.uk](http://www.charitycommission.gov.uk).

<sup>48</sup> As explained in section 1 of the paper, charities below £10,000 income are not required to have their accounts independently examined (although some may do so optionally), but neither are they required to file accounts with the Charity Commission, so there was little point in looking at charities below the threshold. Charities above £250,000 income are subject to a full audit.

Of the remaining 420 active non-company charities:

- a further 145 (35% of the 420) were eliminated as they had not submitted their latest Annual Return or figures for income/expenditure within the time allowed (the trustees of these charities were in breach of the Act<sup>49</sup>);
- 13 (3%) were excluded as they had incomes in excess of £250,000 and would therefore require a full audit;
- 160 (38%) were excluded in that although they had submitted returns to the Charity Commission, their income and expenditure were recorded as "below threshold" (under £10,000).

This left 102 charities for detailed study of the accounts.

Apart from those excluded due to lack of returns, the proportions in each excluded category agree closely with Charity Commission statistics for the Register as a whole. This suggests that the approach described served to achieve a reasonably representative sample of charities.

Arrangements were then made to visit the Charity Commission's offices to review the files of the 102 active unincorporated charities selected. By law, these charities were required to have had an independent examination of their accounts unless they had elected for a full audit.

The latest accounts of each of these charities were inspected individually (by the author, as someone with experience in reading charity accounts) and were scored on sixteen variables as indicated in Table II below.

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<sup>49</sup> Only charities with income or expenditure above £10,000 are *required* to submit a full Annual Return and their Annual Report and Accounts to the Charity Commission (Charities Act 1993 s45 & s48, as amended). However, in order to monitor this requirement, the Commission requires *all* registered charities to complete a simple form each year with details of their trustees and the charity's gross income and expenditure.

TABLE II:

<b>VARIABLES USED TO ASSESS CHARITY ACCOUNTS AS FILED</b>			
(a)	Total income of charity as shown in the accounts (or expenditure if larger)		
(b)	Type of accounts: receipts & payment / accruals / mixed <sup>50</sup>		
(c)	Overall quality of accounts (on a scale from 1 = very poor to 5 = excellent)		
(d)	Type of scrutiny of the accounts: audit / independent examination / nothing / other		
(e)	If the scrutiny appeared to be an independent examination, whether or not the examiner's report included each of the following (yes/no for each):		
	• Examiner's name	• Examiner's address	• Examiner's qualifications
	• Charity name	• Charity year	• Page numbers referred to?
	• Signed report	• Dated report	• Date of IE report not earlier than date of trustees approval
	• States carried out under s43 and in accordance with directions under s43(7)(b)		
	• Includes at least the four minimum assurances required in all IE reports (see 3.3 above)		
(f)	Whether the scrutiny report was qualified.		

Most of these variables were factual, although variable (e) was used as a subjective assessment of the overall quality of the accounts in relation to the requirements of charity law and the Charities SORP (not all the variables are used in the analysis reported in this article.).

On the basis of this data, in particular the contents of the IE's report (if present), it is possible to make a reasonably informed assessment of how far the independent

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<sup>50</sup> Section 42(3) of the Charities Act 1993 as amended allows charities below £100,000 income or expenditure to use a simplified presentation of receipts and payments accounts, but if this is not chosen, the accounts must be presented on an accruals basis in accordance with the Charities SORP (Charity Commission 2000). For charities over £100,000, the accruals format is compulsory. There is no provision for any other format - so a mix of the two approaches is not permitted.

examination regime is understood by those who act as independent examiners.

In addition, where an independent examination appeared to have taken place, the name, address and qualifications of the IE (if shown) were recorded for further analysis.

## **5 Findings**

The principal findings from this accounts study were as follows.

### *5.1 Consideration of Accounts as Filed with Charity Commission*

Of the 102 charities selected for detailed study of the accounts, it was not possible to proceed with sixteen<sup>51</sup>. The remaining 86 sets of accounts were studied and assessed on the variables shown in Table II above. These were all accounts within the preceding two years, covering year ends from 2001 to 2003.

### *5.2 Type of Scrutiny*

All of these 86 charity accounts were eligible for independent examination, and by law were required to have an independent examination unless a full audit was chosen. The results for the type of scrutiny were as follows.

- 7 sets of accounts (8%) had no form of external scrutiny, in breach of the Act.
- 15 cases (17%) appeared to have been subject to a full audit, even though the income and expenditure were both below £250,000 and hence an audit would not generally have been required by law<sup>52</sup>.
- 46 cases (53%) appeared to have had an independent examination of some kind in that the words “independent examination” or “independent

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51 These were eliminated for the following reasons: file not available (6 cases); charity was in fact a company even though not identified from the pre-check of the online register (3 cases); accounts were in fact over the £250,000 audit threshold (3 cases) - this could be due to more recent accounts having been submitted since the online check; charity was below the £10,000 threshold (1 case) - same reason; no recent accounts on file (even though the charity had made an annual return) (2 cases); accounts completely unsigned (1 case).

52 It is conceivable that in one or two cases this might have been a formal requirement due to (i) the income or expenditure having been over £250,000 in one of the previous two years, or (ii) a clause in the charity's governing document or (iii) an agreement with a funder.

examiner” were used in some kind of scrutiny report.

- 18 cases (21%) appeared to have had some form of external report which was neither an independent examination nor an audit in accordance with the Act. This included reports with phrases such as “We have compiled these accounts from the books presented to us” or “I have examined the books and vouchers” or “I certify that the above accounts are in accordance with the books and vouchers presented to me”. A number in the category included the word “audit” but were clearly not audit reports by firms of registered auditors, e.g. Having audited the books and records I have found that the accounts are correct”, or in some cases just a person's name followed by “Hon Auditor”. Some of these did, nevertheless, include an address for the person who had written the report.

### 5.3 *Quality of Independent Examinations*

In the 46 cases classed as having had an independent examination, a proxy for the quality of the examination was obtained by counting the number of points in variable (e) - see Table II above - which were included in the IE's report.

Good practice, such as advocated by bodies such as ACIE<sup>53</sup>, and by much of the guidance from other professional bodies, would require all eleven points to be included in any independent examiner's report. Moreover, apart from the page numbers, the remaining ten points are explicitly required by law to be included in an IE's report<sup>54</sup>, although the requirements to give any relevant professional qualifications held by the IE allows for the possibility that in some cases the IE may not necessarily have qualifications to include. But the remaining nine points are undoubtedly essential to comply with the statutory framework<sup>55</sup>.

Counting each of these points gives a potential score from 1 to 11 for each independent examination observed, where any score below 9 would indicate that the IE had omitted a least some essential element.

Of course, the appearance of a complete independent examination report is no evidence that a thorough and competent independent examination has in fact taken place. There is anecdotal evidence of cases where the wording of IE reports has

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<sup>53</sup> Morgan, Gareth G. Independent Examination: The Basics (in Association of Charity Independent Examiners Annual Handbook and Directory 2004/05 pp12-16).

<sup>54</sup> Charities (Accounts and Reports) Regulations 2005 - regulation 8.

<sup>55</sup> i.e.: The Charities Act 1993, the Charities (Accounts and Reports) Regulations 1995, and the Directions of the Charity Commissioners on the Carrying Out of an Independent Examination (Charity Commission 2001).

simply been copied from other sets of accounts or from the Charity Commissioners' guidance and where the person signing the report has made little or no attempt to carry out a serious examination of the accounts and records (notwithstanding the fact that the IE is signing that he or she has carried out an examination in accordance with “the Directions of the Charity Commissioners under s43(7)(b) of the Charities Act 1993”).

But the negative argument is manifestly a valid measure of independent examination quality: if the IE report fails to include all the items required by law then clearly the independent examination is at least partly defective.

The results of this assessment are as shown in Table III below.

TABLE III:

<b>NUMBER OF POINTS INCLUDED IN INDEPENDENT EXAMINATION REPORTS</b>	
<b>Points included</b>	<b>Number of cases</b>
All 11 points	10
10 points	12
9 points (minimum reqd by law)	13
8 points	5
5 - 7 points	4
3 - 4 points	2
2 or fewer points	0
MEAN POINTS	9.1
TOTAL CASES	n = 46

#### 5.4 *The Independent Examiners*

Out of the 86 accounts considered, and excluding the 7 cases subject to a full audit, in 45 cases a name and address of an examiner was given (this includes some cases classed as “other” forms of scrutiny).

These can be categorised as follows.

- In 12 cases, the only name was that of a firm (this is not correct as under s43 of the Charities Act the independent examiner must be an individual). In most cases this was clearly a firm of accountants, which shows that many professional accountants are not fully familiar with the requirements for independent examination.
- In 18 cases, an individual name was given with a qualification indicating that the person is a member of one of the chartered accountancy bodies. However, only six of these were followed by the name of a firm in the address: the remainder would appear to be qualified accountants acting on an individual basis.
- Four cases give an individual name followed by other qualifications (e.g. bankers, or non-chartered accounting qualifications).
- In 11 cases, an individual name was given without any professional qualifications.

### 5.5 *Qualified Independent Examination Reports*

The sample included two cases of IE's reports with qualified wordings (4% of the independent examination cases). This is too small a number to draw any statistical conclusions, but the appearance of qualified reports suggests that the regime is being taken seriously.

However, the quality of some of the accounts was poor (based on the subjective 1-5 rating). Given that an independent examiner should be reporting if evidence has come to his/her attention suggesting that the accounts fail to comply with the requirements of the Charities Act<sup>56</sup>, a qualified IE report would arguably have been warranted in considerably more cases.

Of the two qualified reports, one related to an uncertainty on the valuation of investments, and the other to doubts about the opening creditors figure.

## **6 Analysis and Implications**

The results of this assessment enable us to make following assertions about the operation of the independent examination regime, at least at a technical level.

First, it is clear that by the time of this study, independent examination was being widely used. As reported above, 53% of those charities which were eligible for independent examination actually included in their accounts what appeared to be an independent examiner's report. Some early discussion of the legislation when it first appeared was cautious about the independent examination regime and whether or not it would be adequate for charities and their funders, and this caution is still to be seen in works as recent as 2003<sup>57</sup>. But this is not borne out by this study. Moreover, only 17% had opted for full audit in place on an independent examination - the remaining 30% of cases are explained by accounts submitted with neither a proper independent examination nor an audit. So, of 70% which were at least attempting to use one of the forms of scrutiny permitted by the Act, there are *more than three times as many charities having independent examinations as having audits*.

Nevertheless, all of the charities in the final sample were non-company charities with incomes in the £10,000 to £250,000 range all of which should, by law, have had either an independent examination or audit. It remains a matter of concern, which the Charity Commission will no doubt wish to address through its regulatory work, that only 70% of charities in the sample (17% audit and 53% independent examination) had a form of scrutiny which was even close to this requirement. Bearing in mind that 35% of active non-company charities were eliminated at the sampling stage, because they had not submitted recent returns to the Charity Commission, as noted above, and a further 2% were eliminated because even though they had submitted returns they had not submitted accounts, the net result is that only 45% of charities in this range had either an audit or independent examination of their accounts - i.e. as many as 55% of charities in the IE range appear to have failed even to attempt to submit validly scrutinised accounts.<sup>58</sup> These statistics are broadly in line with the Charity Commission's own research<sup>59</sup>.

Second, where independent examination has been selected, it appears at least on the evidence of the 11 point checklist used, that most IEs are producing reports which are addressing the legal requirements. Of the 46 cases considered, 35 (76%) included

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57 Arnott, Jane, 2003. *The ICSA Charity Trustee's Guide* (London: ICSA Publishing).

58 This calculation is based on 65% which had filed returns x 98% of these which had submitted accounts x 70% which had an independent examination or audit. However, this is a "worst case" calculation, as it assumes that all of the charities which failed to submit returns and accounts had omitted to have their accounts audited or independently examined. It also assumes that the 65% which filed Charity Commission returns is representative of the £10,000 to £250,000 band - but in practice non-returns are skewed more to the smaller end (under £10,000).

59 Duck, Jacqui. Charity Accounts Study (Presentation to the Charity Finance Directors Group, Leeds, November 2003.)

at least 9 of the expected points in their report. Whilst this does not prove that the underlying independent examination was necessarily carried out completely and correctly, it does suggest a surprisingly high level of compliance with the requirements.

Both of these results are considerably stronger than the earlier study in 2000 by the present author which, in a smaller sample, found 19 independent examinations and eight audits, and only six out of the 19 IE reports in that study were in any way approaching the legal requirements. This suggests that knowledge and experience of the regime is leading both to wider use of independent examination, and significantly improved practice amongst IEs.

Third, with regard to those acting as IEs, it is clear that many firms of accountants have failed to appreciate that an independent examiner must be an individual (this applied to 27% of the independent examination reports - 12 cases out of the 45 where the IE's address was given).

Of the remaining 33 reports where the IE was clearly an individual, only in nine cases was the independent examiner based in a professional firm (at least in terms of the address given) - this included six with chartered accountancy qualifications and three others. Of the others, looking at the qualifications given, there is roughly an equal split between qualified accountants who appear to have given a home address, and IEs with other backgrounds. One IE specifically gave the address of a voluntary organisation after his name, suggesting that he was working as a community accountant.

## **7 Conclusions**

From the analysis of the statutory regime given above, it is clear that independent examination, when properly applied, forms a very effective basis for scrutiny of charity accounts, going well beyond the informal audits of the past.

The fieldwork reported here supports the tentative conclusions from earlier studies, that the independent examination regime is enabling a wide range of individuals who are not necessarily qualified accountants to undertake a significant form of accounts scrutiny which is sufficient to satisfy most users of charity accounts up to £250,000 income. There is ample justification for increasing the upper income limit at which charities can have an independent examination, as in the new Charities Bill.

Earlier work<sup>60</sup> found a very wide range of individuals willing to undergo training with ACIE to become independent examiners, most of these being clearly people

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<sup>60</sup> Morgan (2003). *A Statutory Regime for "Lay Audits"* (op cit).

within the voluntary sector. Many are very willing to undertake the training necessary to become competent examiners, and are willing to put that training into practical effect when given the opportunity. The present study shows that this diversity is reflected in a random sample of independently examined accounts filed with the Charity Commission.

It is certainly *not* the case that most charities needing an independent examination have had to look to firms of accountants to find an independent examiner, nor it the case that such approaches are getting the best results, given that a high proportion of the firms had provided independent examination reports in the name of the firm rather than an individual IE as the law requires. This is born out by the experience of the ACIE Council in considering applications for Full Membership, which has reported roughly similar acceptance and rejection rates for qualified accountants and other applicants<sup>61</sup>.

As far as can be discerned from the published accounts alone, only just over half of those acting as IEs are qualified accountants; the rest have a range of other qualifications or none at all. Many of the qualified accountants have given what appear to be home addresses: some of these may be sole practitioners in practice at home addresses, but it is likely that this group includes some acting as a voluntary IEs, and thus presumably acting out of a commitment to the voluntary sector. The non-accountants who form the other half of the IEs in the sample represent a broad cross section of individuals, some with other qualifications, and others with no qualification at all listed on their examination reports.

The fact that several hundred such individuals are willing to join a professional body (ACIE), often giving up time to attend training courses, and with many beginning to obtain a professional qualification through that body, is further evidence that there is a genuine willingness by IEs from a wide range of backgrounds to take their duties seriously.

However, the significant proportion of charity accounts in the present study which contained problems demonstrate the need for more training and support for IEs - this includes professional accountants as well as others. There is also a need for more action by the Charity Commission to ensure charities submit proper accounts: this has been a major theme of the Commission's work in the last two years<sup>62</sup>, including a recognition of the role that auditors and independent examiners play in this<sup>63</sup>, which

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61 *Evidence submitted by ACIE to the Joint Scrutiny Committee on the Draft Charities Bill* (op cit).

62 Charity Commission. *Accounts Aren't Optional* (Press release Sept 2003).

63 Stoker, John. *Address to ACIE Conference 2004* (op cit).

has received support from others<sup>64</sup>. But standards in this study appear to be considerably higher than the preliminary study in 2000, suggesting that knowledge of the IE regime is being disseminated and leading to improved practice.

So, we can safely conclude that charity independent examiners do indeed offer an effective form of statutory self-regulation within the voluntary sector. The fieldwork from the charity accounts study, based on a random sample of charities, has shown charities are widely opting for independent examinations, but that only a minority of the IEs are in firms of accountants. The rest would appear to be individuals acting directly for charities, and in most cases we can reasonably assume that they do so because of some existing involvement in the sector. More work is needed to establish the nature and extent of involvement by IEs with the sector (apart from their IE work), but the evidence from the ACIE membership supports the premise that many IEs are deeply immersed in the sector.

As regards the effectiveness of the regime, it is clear that in most cases when a charity has an independent examination of its accounts, the IE's report covers the main statutory requirements. More work is needed to look at the processes undertaken by individual IEs, but it appears that the main elements of the regime are translating into practice. There is no way the Charity Commission could directly investigate the financial affairs of hundreds of thousands of smaller charities, and for charities over £10,000 income (those which are formally monitored by the Commission), the reports of auditors and IEs (but primarily IEs) are essential to the process.

The UK therefore appears to have successfully introduced a regime where the vast majority of charitable organisations whose accounts are subject to a statutory requirement for external scrutiny have their accounting compliance monitored on a statutory basis by individuals from within the third sector.

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<sup>64</sup> *Association of Charity Independent Examiners Welcomes Charity Commission Campaign on Charity Accounts* (Press Release Oct 2003 - available at [www.acie.org.uk](http://www.acie.org.uk)).