

Institution: Sheffield Hallam University
Unit of Assessment: 19 Business and Management Studies
Title of case study: Simplifying Audit Requirements for Smaller Charities
<p>1. Summary of the impact</p> <p>A body of research carried out at Sheffield Hallam University has led to significant changes in the accounting requirements for charities in England and Wales. Two sets of impact are presented: (A) simplified audit requirements for smaller charities from 2008/09 through enhancement of an alternative regime of 'independent examination' (IE), and (B) Government acceptance in 2012/13 of the case for further simplifications in charity regulation. Over the period 2009-13 at least £15 million of charity resources has been released from mandatory audits for charities to spend on work with beneficiaries. Further benefits to the sector will follow from the latest developments.</p>
<p>2. Underpinning research</p> <p><i>The research issue:</i> Effective application of charity law is crucial to many policies relating to the wider third sector and the social economy. The Charities Act 1993 created a statutory framework for financial reporting by charities in England and Wales which took effect from 1997. However, from the outset there was evidence of difficulties and/or high costs in its application, especially for small/medium charities.</p> <p>Provision was made in the Charities Act 2006 for substantial changes to this – changes which were finalised and implemented from 2008/09. The research discussed below contributed significantly to those changes (which are now consolidated in the Charities Act 2011). Further changes were accepted in principle by Government in 2012/13.</p> <p><i>The team:</i> The research (over the period 1999-2013) has involved eight separate but linked studies of accounting and regulatory issues faced by charitable organisations in the UK. These have led to 15 papers in refereed journals such as <i>Voluntas</i>, <i>Public Money & Management</i>, and <i>Voluntary</i></p> <p><i>Sector Review.</i> Some of the external funders for these studies are listed in section 3. The research team was led by Professor Gareth G Morgan (Senior Lecturer 1995-2007, and Professor of Charity Studies 2007-present at Sheffield Hallam University) with support from colleagues including Neil Fletcher (Senior Lecturer in Accounting 2009-present at Sheffield Hallam University).</p> <p><i>The research scope:</i> Initially, several studies examined the impact of the Charities Act requirements on charity treasurers and finance workers and the consequences for financial reporting in charities of different sizes [3.1 & 3.3], then on the impact of the accounting regime on charitable status more generally [3.4] and later on levels of compliance [3.5]. These studies used a combination of normative analysis together with qualitative and quantitative fieldwork.</p> <p><i>Focus (A):</i> The role of charity independent examiners (IEs) was the first major focus [3.1; 3.2; 3.5] and this research had major impact on subsequent charity audit requirements. In each UK jurisdiction, larger charities are required to have a full professional audit of their accounts, with smaller charities allowed to opt for independent examination. The IE regime allows an independent person who is not necessarily a qualified accountant to report on the accounts of a charity below the audit threshold, but the IE must follow a ten stage programme of directions specified by the Charity Commission [5.6] and must report under seven criteria specified in secondary legislation (in the <i>Charities (Accounts and Reports) Regulations 2008</i>).</p> <p><i>Findings (A):</i> These studies considered the effectiveness of the IE regime, the nature of IEs as a profession and the need for professional qualifications. They found that the IE framework was largely a very effective means of scrutiny for the accounts of small/medium charities, especially when they were well trained and supported. But they also identified complexities which arose as a result of different regimes applicable to charitable companies as compared to charitable trusts and associations: in particular charities structured as companies even if below the audit level could not benefit from IE, but had to use a much less satisfactory (and generally more expensive) arrangement of appointing a 'reporting accountant' under company law. These findings were</p>

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critical to the subsequent impact (see section 5). The status of the IE regime and its reform as a result of this research is assessed in retrospect in a journal paper [3.4].

Focus (B): Morgan and Fletcher, together with a team of research associates, undertook a major study for the Charity Commission in 2010/11 [3.5] regarding a new charity reporting requirement. From 2008/09, charity trustees were required to explain in their annual reports how the charity had advanced its charitable purposes 'for public benefit'. This is known as 'public benefit reporting' (PBR). (The 'public benefit' requirement is a fundamental issue in the definition of a charity.) The study reviewed 1400 sets of charity reports and accounts, and interviewed trustees and senior staff regarding the processes. Further theoretical work deriving from this study regarding wider issues of non-profit accountability has now been published in the international journal *Voluntas* [3.6].

Findings (B): The study found relatively poor compliance with PBR and with several related issues in the charity accounting and reporting requirements. But it also found strong support for the principles of PBR as a means of demonstrating charity accountability in terms of public benefit.

3. References to the research

[3.1] Morgan, G.G., 2005. 'Charities and Self-Regulation: Theory and Practice in the Role of Independent Examiners under s43(3) of the Charities Act 1993' (*The Charity Law and Practice Review* 8(3) 31-54). [Submitted in RAE 2008]. URL: <http://shura.shu.ac.uk/id/eprint/5588>

[3.2] Morgan, G.G. 2006. 'Scrutiny, examination, review or audit: alternative models for reporting on the accounts of smaller charities'. *British Accounting Association Annual Conference* Portsmouth – April 2006).

[3.3] Morgan, G.G. 2010. 'The Use of Charitable Status as a Basis for Regulation of Nonprofit Accounting', (*Voluntary Sector Review* 1(2): 209-232). DOI: <http://dx.doi.org/10.1332/204080510X511256>

[3.4] Morgan, G.G. 2011 'The role of independent examiners in the accountability of UK charities', (*Public Money and Management*, 31(3): 183-192) (REF output 1). DOI:10.1080/09540962.2011.573229

[3.5] Morgan, GG & Fletcher, NJ. (2011) *Public Benefit Reporting by Charities – and Foreword by the Charity Commission* (ref: RS25 Liverpool: Charity Commission) http://www.charitycommission.gov.uk/media/92903/public_benefit_reporting_shu.pdf

[3.6] Morgan, GG & Fletcher, NJ (2013) *Mandatory Public Benefit Reporting as a Basis for Charity Accountability: Findings from England and Wales* (*Voluntas* published online 8 May 2013. DOI 10.1007/s11266-013-9372-7). (Morgan REF output no. 4).

Research grants and contracts

2006-08: Finance Hub (a Government programme administered through the Charities Aid Foundation): £23,000 for evaluation of Community Accountancy Services and Funding Advice Services in England (two studies) (PI: GG Morgan).

2005-08 Association of Charity Independent Examiners: £6,000 for *Analysis of the implications of receipts and payments accounting by smaller charities* (PI: GG Morgan).

2010-11: Charity Commission: £40,000 for study of *Public Benefit Reporting by Charities* (PI: GG Morgan).

2011-12: Charity Commission: £20,000 for study of *Perception and Impact of the Public Benefit Requirement under the Charities Act 2006* (in partnership with Institute of Voluntary Action Research – IVAR – at Birkbeck University of London) (PI: L Baker – IVAR).

4. Details of the impact

This research has led to acceptance by both the past and present Governments of several changes to the regulatory framework to facilitate more effective financial reporting by charities.

Two key impacts are highlighted – the first was implemented in law from 2008/09 and has already led to direct benefits of around £15 million for charities, as explained below. The second has been accepted by Government in policy terms as creating a case for further reform.

(A) Changes to the regulatory framework of IEs, triggered by the research above, have extended the regime for independent examination of charity accounts – it is now available to almost all charities in England & Wales up to £500,000 income (previously only to non-company charities up to £250,000 income). Over the period 2009-13 this has delivered possible savings of at least £15 million for charitable companies in the income band £250,000 to £500,000 which are

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now able to have an IE rather than an audit (see below for computation).

The changes have also led to recognition of a new professional body in this field – the Association of Charity Independent Examiners (ACIE) – now listed in Charities Act 2011 s.145(3).

This impact can be explained through a series of events as explained below, leading to substantive impact on charities from 2009. (i) Lord Hodgson (an opposition peer) drew directly on Morgan's work to present arguments to Parliament which were eventually carried in the Companies Act 2006; (ii) using powers from Hodgson's company law amendment, the Charities Act 1993 was amended in 2008; (iii) the Charities (Accounts and Reports) Regulations 2008 were made allowing IE for charitable companies for charity accounting years ending 31 March 2009 onwards.

The process: The initial case for change to the legislation on IEs in the Charities Act 1993 arose at least partly from policy submissions made by Morgan (through ACIE) drawing on his research [3.1] for Government and Parliamentary consultations on issues of charity regulation [5.1]. As the legislation was proceeding through Parliament in 2006, the research was directly used by Lord Hodgson (and supported by other peers and MPs) to make possible a fundamental change allowing the extension of the IE regime to charitable companies (previously it only applied to non-company charities). Hodgson contacted ACIE for any relevant research and was sent a copy of Morgan's paper [3.2]. This led him to raise the issue initially in the Charities Bill debate [5.2] and then to table formal amendments to the Companies Bill – amendments which had been drafted by Morgan [5.3] for ACIE based on this research. After a 40 minute Lords debate on this sole issue, it was put to a vote and carried as rare Opposition majority [5.4]. The changes were debated further in the Commons when the two Bills were both coming to completion [5.5]. This created a power in s.1175 of the Companies Act 2006 allowing the Business Secretary to make regulations amending the scrutiny regime for charitable companies which became s.77 of the Charities Act 2006.

However, these were only enabling provisions: consultations followed on whether to bring them into force: final implementation arose only through *The Charities Act 2006 (Charitable Companies Audit and Group Accounts Provisions) Order 2008* (SI 2008/527) which further amended the Charities Act 1993 with effect from 1 April 2008. The new IE framework was set out in the *Charities (Accounts and Reports) Regulations 2008* (SI 2008/629) which, using the powers in the legislation above, formally prescribed an IE framework for charitable companies for years starting on or after 1 April 2008 (i.e. years ending 31 March 2009 onwards). A completely new version of the Charity Commission's Directions to IEs was issued in 2009 to reflect the new framework [5.6].

Effect of the research: The Parliamentary records make clear that it is most unlikely these changes would have taken effect without the use of this research to provide the arguments.

Measuring the impact: Charity Commission figures from 2008 show 5,500 registered charities in the income band £250,000 to £500,000. Of these, which 58% – over 3000 – are structured as companies [5.7]. These are typically providing key services in local communities.

From 2009 year ends onwards, each of these was able to have an IE rather than an audit, at a typical saving of approximately £1,000 in fees (a typical difference in cost between an audit and IE – evidence from data used in [3.1 & 3.4]). For the 3000+ charitable companies affected, this means a saving of $3000 \times £1,000 = £3\text{million}$ per year from 2009 or £15million over the REF period up to 2013. The savings meant resources released for other costs – in most cases this would be spent directly on work with beneficiaries of these charities. A further 4,700 charitable companies under £250,000 income [5.7] have also gained a clear charity-specific form of accounts scrutiny (which is typically also less costly) by use of IEs rather than reporting accountants under company law.

(B) Further reforms to charity reporting and IE arising from this research, particularly the later work on "public benefit" issues, have now been accepted as a result of Lord Hodgson's appointment in 2011 as Independent Reviewer of the Charities Act 2006.

His 2012 report to Parliament cited Sheffield Hallam University studies on issues of charity regulation on three occasions, showing problems in the existing regime: "[T]he ability, or perhaps in some cases the willingness, of the sector to fulfil the reporting requirement is far from certain; compliance is very low. Research conducted by Sheffield Hallam University for the Charity

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Commission found that, among charities with income of over £500,000, only 25% fully met the requirement in their 2009/10 report. Subsequent research by the Institute of Voluntary Action Research, with Sheffield Hallam University, has also found that charities see the renewed emphasis on public benefit as part of the modernisation of the sector.” [5.8 p28] “Finally, evidence indicated that the Trustees Annual Report ... does not always provide a sufficiently detailed explanation of [the charity’s] work and its impact. This is borne out by the research conducted by Sheffield Hallam University into compliance with public benefit reporting requirements.” [5.8 p68]

Hodgson expressed concern at the levels of compliance reported by Morgan & Fletcher [3.6] and called for stronger PBR stating “Charities should recognise the importance of public benefit reporting both to public confidence and their own ability to attract supporters”. [5.8 p42]. He also recommended further extending the IE regime to charities up to £1M income and removing an unhelpful assets threshold [5.8 p128] which had also been highlighted in the research [3.1; 3.5]. Many of Hodgson’s recommendations, including proposals which were evidenced by the Sheffield Hallam University research, have now been accepted in a Government response [5.9, p22 & 32].

The beneficiaries of these changes are all those who are served by the work of the charities concerned: resources previously spent in inappropriate audit work were released to support charitable work. Secondly there is a benefit to the public at large in that better understanding is available of the work of charities, given an improved reporting and scrutiny regime and better PBR, and more confidence that the tax concessions available to charities are effectively used.

Further evidence of this impact on charity regulation appears in various professional journals and newsletters used by charity practitioners. In particular, the findings of the SHU work on public benefit reporting [3.6] and its implications for changed practice are drawn to the attention of all 180,000 registered charities in a Charity Commission newsletter [5.10].

5. Sources to corroborate the impact

Note: Although the key impacts arose from 2009 and 2012 respectively, sources 5.1-5.5 are cited to show the chain of decision making which led to these changes, as explained above. Sources 5.1, 5.2, 5.4 and 5.5 are publicly available; locations of all other sources are noted below.

- [5.1] Millburn, A (ed). *House of Lords/House of Commons Joint Committee on the Draft Charities Bill* Vol III Written evidence (HL Paper 167-III, pp 380-386, 2004).
- [5.2] Lords Hansard 7 March 2006: *Charities Bill Grand Committee*, cols GC277–284.
- [5.3] E-mail 26 January 2006 from Fiona Gordon (ACIE Director) to Lord Hodgson attaching proposed the amendments to the Companies Bill which Morgan had drafted. Available from the University on request
- [5.4] Lords Hansard 10 May 2006, *Companies Bill Report Stage* cols 960–964.
- [5.5] Commons Hansard 19 Oct 2006 & 25 Oct 2006 *Companies Bill [Lords] Report Stage Proceedings*.
- [5.6] Charity Commission (2009), *Independent Examination of Charity Accounts: Examiner’s Guide* ref CC32 (Liverpool: Charity Commission). For latest (2012) version see www.charitycommission.gov.uk/media/94059/cc32text.pdf
- [5.7] Hind, Andrew (Chief Executive of the Charity Commission) – Presentation at “SORP and Charity Reporting: The way ahead” Charity Commission/OSCR Stakeholder Forum 25 April 2008. Available from the University on request.
- [5.8] Hodgson, Lord R (2012). *Trusted and Independent: Giving charity back to charities - Review of the Charities Act 2006* (Presented to Parliament by the Minister for the Cabinet Office July 2012) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/79275/Charities-Act-Review-2006-report-Hodgson.pdf
- [5.9] Minister for the Cabinet Office (2013), *Government Responses to the PASC’s Third Report of 2013-14 and Lord Hodgson’s Statutory Review of the Charities Act 2006* (Cm 8700) www.gov.uk/government/uploads/system/uploads/attachment_data/file/237077/Response-charities-legal-framework.pdf
- [5.10] Charity Commission *Reporting on Public Benefit – a chance to show your impact* (Charity Commission News Summer 2011, 2). Available from the University on request.