Civic Engagement through Voluntary Involvement in Regulation of the Third Sector

L’enagement civique par la participation volontaire dans la réglementation du tiers secteur

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INTRODUCTION

Civic engagement frequently involves voluntary participation in the activities of third sector organisations (for example, by serving as a voluntary board member/trustee, or by undertaking a voluntary role in service provision) – indeed many would see such engagement as forming the essence of the third sector. On the other hand, civic engagement can also take the form of promoting citizenship in terms of respect for the law (for example, by serving as a lay magistrate). However, it is suggested that forms of civic engagement which combine both these dimensions, especially on a voluntary basis, are rare.

This paper analyses one such example of voluntary civic engagement which combines the dimension of third sector participation with the dimension of support for law and regulation: the role of independent examiners of charity accounts in the UK.

Those who undertake this role are frequently volunteers, who choose to take on a rule of serving the third sector by assisting in the scrutiny of charity accounts, and hence providing a regulatory regime (Morgan 2004b).
Audit and Independent Examination

In the UK, the majority of voluntary and community organisations have aims which are classed as charitable\(^1\) in law, and are thus subject to a wide range of legislation\(^2\) concerning the operation of charities.

The Charities Acts 1992 and 1993 and equivalent provisions in Scotland, introduced for the first time in the UK a general statutory regime for scrutiny of charity accounts (Morgan 1999). In England & Wales, the legislation currently requires charities over £250,000 income to have their accounts audited by a registered auditor, but below this a charity may opt for an *independent examination* of its accounts (Picarda 2001). (This threshold is due to change, the implications of which are considered further below.)

The principles of charity audits by professional auditors is well established, and supported by specific guidance from the Auditing Practices Board (2002) but only 7% of registered charities have sufficient income for an audit to be required by law (Charity Commission 2004a), so in the majority of cases, the accounts are likely to be scrutinised by an independent examiner.

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*\(^3\). 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 (CANN 2004). Other IEs are specialist consultants working with voluntary organisations, who are heavily involved in a cross section of voluntary sector issues.

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1 At present, the nature of charity is defined only by case law, but the proposed Charities Bill (House of Lords 2004 clauses 1-5) will define "charity" in terms of twelve possible heads of charitable activity, combined in each case with the principle of public benefit. The vast majority of voluntary organisations whose aims are broader than the personal interests of their own members, and which are not specifically political, fall within this definition.

2 In particular, for charities in England & Wales, the Charities Acts 1992 & 1993.

3 Charities Act 1993 s43(3).
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\(^4\) (see further below). So, the process is much more than an informal checking of the books, and requires a well-planned audit process, in the broad sense of the term. An independent examiner's report must express an opinion on a minimum of four issues, and in some cases up to seven, each of which may require some measure of qualified wording.

Those acting as independent examiners are, in practice, exercising a major regulatory role on behalf of the Charity Commission (the Government department responsible for charities) in ensuring that charitable organisations comply with a range of statutory requirements (Charity Commission 2003b). In fact the former Chief Charity Commissioner described independent examiners as "invaluable allies" in the Commission's task of improving the transparency and accountability of charities (Stoker, 2004). It follows that the role of IEs in terms of civic engagement is immense.

**Policy Changes**

Soon after the Charities Act 1993 was passed, a process of deregulation (Baring 1994a p9-10; 1994b, p9) led to the conclusion that the initial audit threshold of £100,000 was too low and this was increased to £250,000. At the same time, a “light touch” regime was created whereby charities below £10,000 income were exempted from any requirement for independent scrutiny of their accounts\(^5\). So for the last ten years, independent examination has generally been applicable to charities in the £10,000 to £250,000 income range\(^6\).

A decade on from the 1992/93 Acts, the UK is facing a further major review of charity regulation, with new Charities Bills now before Parliament both for England and Wales (House of Lords 2004) and for Scotland (Scottish Parliament 2004) and a review of charity law has just

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\(^4\) Charities Act 1993 s43; Charities (Accounts and Reports) Regulations 1995; Directions of the Charity Commissioners on the Carrying Out of an Independent Examination (Charity Commission 2001).

\(^5\) By The Deregulation and Contracting Out Act 1994, and by The Charities Act (Substitution of Sums) Order 1995 (SI 1995/2966). All amounts in the legislation are expressed in Pounds Sterling as the UK in not yet a member of the eurozone, but in round numbers, independent examination applies to charities with incomes in the range €14 000 to €360 000. See Morgan (2004) for comments on the implications for charities if and when the UK adopts the euro.

\(^6\) The accounting provisions of the Charities Act 1993 relate to charities which are not structured as companies: charitable companies are subject to slightly different requirements under company law.
begin in Northern Ireland (Department for Social Development 2005). Much of the debate in each jurisdiction has focused on issues such as the criteria for charitable status, in particular issues of how charities are to demonstrate "public benefit".

However, important changes are also being considered to the requirements for scrutiny of accounts, which have received less attention.

As public benefit entities, charities have long been subject to a requirement to publish accounts, to have them subjected to a form of independent scrutiny (depending on income) and in most cases to file them with the Charity Commission, as part of the regulatory process. The thresholds for this are much lower than for commercial companies. But a review of charity law launched by the Prime Minister following the 2001 General Election, expressed a desire to reduce the burden of regulation on voluntary activities (Pratten 2004). One of the proposals which emerged was an increase in the charity audit threshold up to £1M, allowing a wider range of charities to opt for independent examination of their accounts (Cabinet Office 2002).

However, there was concern, particularly from established professional bodies, about the risks of quite substantial charities having inadequate scrutiny of their accounts. As a compromise, the Home Office therefore proposed an increase in the audit threshold to £500,000 income combined with a requirement for an independent examination by a professionally-qualified independent examiner for charities now released from audit (those in the £250,000 to £500,000 band) (Home Office 2003). This was included in the Draft Charities Bill for England and Wales published in May 2004 (Home Office 2004, clause 22) and extended into the actual Bill presented to Parliament (House of Lords 2004, clause 27).

The end result, if approved by Parliament, will be a scrutiny regime with four separate levels, as shown in Table I.
<table>
<thead>
<tr>
<th>Gross Income of Charity</th>
<th>Minimum Permitted Scrutiny of Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; £10,000</td>
<td>Approval of accounts by trustees only - no external scrutiny required</td>
</tr>
<tr>
<td>£10,000 to £250,000</td>
<td>Independent examination by an examiner of the charity's choice</td>
</tr>
<tr>
<td>£250,000 to £500,000</td>
<td>Independent examination by a professionally qualified examiner</td>
</tr>
<tr>
<td>&gt; £500,000</td>
<td>Audit by a registered auditor</td>
</tr>
</tbody>
</table>

The figures in the table will apply to charities in England and Wales which are not constituted as companies\(^8\) - slightly different arrangements apply to charitable companies (governed by the Companies Acts) and different thresholds apply in Scotland, but these are not considered further in this paper.

**Accountability of Charities**

Given the lack of a profit motive and hence the lack of any accountability through a return to investors, one of the most basic ways in which charities may demonstrate accountability is through the independent scrutiny of its published accounts. The vast majority of charities hold funds in trust, often given at arms length by donors with no expectation of any personal recompense and little scope for monitoring the use of the funds they have given. Most charities

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\(^7\) The proposals will also be further complicated by an asset test which will require charities in the £100,000 to £500,000 income range to have an audit if their assets exceed £2.8M. The implications of this are not explored in this paper.

\(^8\) 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 the Charities Act 1993 s50. Also, the new Charities Bill (House of Lords 2004, clause 32) proposes a new legal form - the 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: incorporated charities such as PCCs (at present) and CIOs (in future) fall within the regime.
receive substantial tax reliefs (Vincent & Francis, 2001; Morgan 2002a, Palmer & Randall, 2002) and many charities hold funds to deliver services commission by the public sector (HM Treasury 2002). For all these reasons, accountability of charities in seen as an important issue, where the state has the right to impose a regulatory regime considerably more rigorous than that applicable to commercial businesses (Woodfield 1987; Home Secretary 1989): both in terms of publication of accounts, and in terms of requiring the accounts to be independently scrutinised.

Where, as in the case of independent examination, that scrutiny is less than a full audit, the key questions are firstly whether it is effective in satisfying the needs of users of charity accounts (such as donors, funders, and regulators) and secondly whether it is effective from the point of view of the charities themselves: in particular, whether small to medium charities are able to find suitable people to act as their independent examiners, rather than having to use audit firms. The emphasis of this paper is on the second of these questions.

These questions lead us to ask whether independent examination represents an appropriate level of scrutiny for the accounts of these charities. On the one hand it can be argued that anything less than a full audit offers insufficient assurance (e.g. Arnott (2003)). Conversely it can be argued that the statutory regime of independent examination poses an excessive regulatory burden on smaller NGOs, given that it requires much more than the "informal audits" of the past (Rochester (2001) notes the huge increase in the regulatory burden on the voluntary sector which has emerged in recent years).

The paper explores this issue - of whether independent examination represents an appropriate level of scrutiny - through an analysis of the legal requirements of the regime, tested in the context of qualitative and quantitative fieldwork. It begins with a review of prior work, and then proceeds to describe and analyse the legal basis of the independent examination regime. The fieldwork methods are then explained, followed by an outline of the fieldwork results, and conclusions are presented in the light of the proposal to increase the audit threshold.

**Previous Work**

Although there is now a good deal of published analysis of the accounting and reporting requirements of UK charity law (e.g. Williams & Palmer 1998; Connolly & Hyndman 2001; Palmer et al 2001; Palmer & Randall, 2002; Connolly & Hyndman 2004) these studies focus almost entirely on the financial statements, rather than on the audit or independent examination
of the accounts, and in any case, most of the charities in these studies have incomes well above the upper limit for independent examination.

The rationale for audit of charity accounts is considered by Palmer & Vinten (2001), and Beattie et al (2001) offer an extensive analysis of audit fee determinants in the sector, but neither of these papers addresses the issues in scrutiny of accounts of charities below the audit threshold. At an international level, a review of charity audit requirements is offered by Palmer (1997) in terms of government regulation and by Jegers (2002) from an economics perspective. Palmer found no other European counties having anything equivalent to independent examination in the UK. Jegers makes some significant comments about the cost of auditing and accounting compliance for smaller nonprofit organisations, but his analysis based on economic theory - it does not consider specific accounting regimes.

An important study by Hyndman (2001) addresses the information needs of users of charity accounts, at least in terms of donors to fundraising charities, but although his study found some donors wanted to see audited financial statements, there is no explicit consideration of how far donors are interested in the audit reports themselves (and the sample was drawn entirely from donors to large charities, so independent examination was not applicable). On the other hand, Bekkers (2003) states that donors find it hard to use formal accounting data and reports on an alternative approach to charity accreditation for donors in the Netherlands. Ebrahim (2005) explores the issue of NGO accountability more generally, and notes that audited accounts may figure in this, but his focus is on the critique of evaluation as a means of achieving accountability to funders.

Thus, there seems to have been little or no academic consideration (apart from prior work in the present study) of the independent examination regime, whether from the point of view of practitioners or in terms of users of financial statements, even though, as noted above, many more charities are subject to independent examination rather than audit.
THE NATURE OF THE INDEPENDENT EXAMINATION REGIME

Statutory Requirements

Within the current independent examination band (non-company charities with incomes in the £10,000 to £250,000 range) two quite different systems of accounts presentation are permitted (Chitty & Morgan, 2001; Morgan 2002a). Up to £100,000 income, charities are allowed⁹ to prepare receipts and payments (R&P) 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 the Charities SORP (Charity Commission, 2000; 2005). The statutory regime applies to excepted charities¹⁰ as well as to registered charities.

In scrutinising accounts, whether prepared on an R&P or accruals basis, the duties of IEs are spelt out in some detail by regulations¹¹. Furthermore, the Charity Commission is empowered¹² to make directions (not just guidance) on the carrying out of an independent examination, which requires that an IE must proceed through a twelve stage process (Charity Commission 2001). For example, an IE 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) - and in extreme cases, where an examiner believes that a trustee has been involved in "deliberate or reckless misconduct" the IE has a whistleblowing duty, to inform the Charity Commissioners directly – as explored by Picarda (2001).

The reporting duties of IEs are expressed in terms of a "negative assurance" in four key areas. To paraphrase the precise reporting duties, a normal unqualified independent examiner's report declares that in material respects, and after carrying out all the required procedures:

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⁹ Charities Act 1993 s42(3), as amended.

¹⁰ 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 – at present this category includes most churches, scout or guide groups, armed forced charities, and others. The new Charities Bill (House of Lords 2004, clause 9) will considerably reduce the category of excepted charities.

¹¹ Regulation 7 of the Charities (Accounts and Reports) Regulations 1995. The 1995 Regulations are due to be consolidated into a new set of Charities (Accounts and Reports) Regulations 2005 which are currently subject to consultation (Home Office 2004b) but no changes are proposed in the duties of IEs.

¹² Under s43(7)(b) of the Charities Act 1993.
• 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.\textsuperscript{13}

\textbf{Operation of the Regime}

The vast majority of charities, by number, are small voluntary organisations, or grant-making trusts with modest financial resources. As noted, only 7\% of registered charities in England and Wales (Charity Commission 2004a) have incomes over the current £250,000 audit threshold. 61\% are very small charities with incomes below £10,000 with no statutory requirement for external scrutiny of their accounts (i.e. their accounts only require signature by the charity's trustees).

This leaves a 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 (ACIE 2004b, 2004d) indicates that 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.

Occasionally a charity which will want the assurance of an audit even if its income is below the required thresholds, or may have to have an audit to satisfy a funder or governing document.

\textsuperscript{13} An independent examiner's reporting duties in England & Wales are detailed in reg 7 of the Charities (Accounts and Reports) Regulations 1995. In addition to the four areas above (which must \textit{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.
But for most charities, independent examination potentially offers an attractive alternative, going much further than the "informal audits" of the past, yet without needing a registered auditor. As explained above, the nature of the regulatory framework means that an IE who carries out his or her duties effectively is in fact undertaking a very comprehensive scrutiny.

As with audit reports, an independent examination 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 small businesses - for example by donors (Hyndman 2001) and by grant-makers (Ashford & Clarke 1996; ACF 2005). Once the implications of a qualified report are understood, in practice, this creates a strong pressure on charity trustees and staff to manage things in a way that will avoid a qualified IE report. For example, examiners will normally ask questions about restricted funds, which encourages charities to handle fund accounting properly in the first place (Charity Commission 2005).

**Effectiveness**

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.

**Support of Independent Examiners**

Despite the importance of IEs in terms of civic engagement and in supporting the regulation of charities, no formal support to IEs is provided by Government or the Charity Commission, beyond the publications mentioned and occasional provision of speakers for events. However, an Association of Charity Independent Examiners (ACIE)\(^\text{14}\) was formed in 1999 to provide "support, training and professional qualifications" to independent examiners throughout the UK; the author served as its part-time General Secretary from 1999 to 2004. ACIE is both a professional body, and a charity in its own right seeking to advance the effectiveness of other

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\(^\text{14}\) Further details of the Association are available from: Association of Charity Independent Examiners, Bentley Resource Centre, High Street, Bentley, Doncaster DN5 0AA, UK. Tel: + 44 1302 828338. Website: www.acie.org.uk. E-mail info@acie.org.uk.


charities (ACIE 2004a). ACIE provides a wide range of publications and training events to support IEs.

**RESEARCH METHODS**

The statutory framework for accounting under the Charities Act 1993 took effect for accounting periods starting on or after 1 March 1996\(^\text{15}\). Allowing time for charities to complete an accounting year and prepare accounts, the first statutory independent examinations in England and Wales took place in 1997 and 1998. Accordingly there is a now a good six years experience of the regime, on which to conduct fieldwork.

**Previous Fieldwork**

Some initial work by the present author (Morgan 2002c, 2003) sought to examine the operation of the regime 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 - see below; 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).

A more extensive survey of ACIE members in early 2004 (sample 408, 39% response rate) indicated a wide cross section of people becoming involved in independent examining (ACIE 2004b). By summer 2004, over 500 individuals were involved in the Association. Sixty-five of these had by then achieved Full Membership of ACIE\(^\text{16}\), but of these only 34 (52%) also held membership of one of the chartered accountancy bodies (ACIE 2004e). 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 people are willing to commit themselves in a civic engagement capacity not just in taking on the duties of an independent examiner, but in many cases are subject themselves to the rigours of seeking admission to a professional qualification in the field.

\(^{15}\) Charities (Accounts and Reports) Regulations 1995 Reg 1.

\(^{16}\) 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 ACIE 2004e). 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 Use of Published Accounts

The insights from these studies served to provide significant themes for further investigation, but they were not necessarily conclusive in terms of the operation of the regime: in particular, 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 for looking at random samples of registered charities whose accounts may have been independently examined.

This was first attempted as a small scale study in the year 2000, but this initial survey 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 (Morgan 2000). 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 (Charity Commission 1995; 2000), rather than the requirements of audit and independent examination.

The Present Charity Accounts Study

It was therefore felt that a much more substantial study of accounts filed at the Charity Commission should be conducted in the second half of 2003, by which time the regime would have been in force for all charities for at least five years; this latest study also sought to record key variables from the financial statements in a way that would permit systematic analysis.

This study was planned as follows. It was decided to consider 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, and to gain some indication of those acting as IEs from a perspective of civic engagement.

To obtain a final sample of 100 charities meeting this criterion, 700 registered charity numbers were chosen initially from various dates of initial registration. For each of these 700 charities,
the online register of charities (Charity Commission 2003a) was inspected to determine: (a) whether the charity was active (as opposed to former charities which had been de-registered); (b) the nature of its governing document (so that charitable companies could be eliminated); (c) whether the charity had submitted returns to the Charity Commission within the last two years; and (d) 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\(^\text{17}\). From the initial 700, this left 102 charities for detailed study of the accounts.

The 598 which were eliminated 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. Of the remaining 420 active non-company charities, 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 (such charities were in breach of the Act\(^\text{18}\)); thirteen (3%) were excluded as they had incomes in excess of £250,000 and would therefore require a full audit. A further 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).

Apart from those excluded due to lack of returns, which necessarily do not appear in Charity Commission statistics, the proportions in each excluded category agree closely with the statistics for the Register as a whole (Charity Commission 2004a). This suggests that the approach described served to achieve a reasonably representative sample of charities.

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\(^{17}\) As explained earlier in 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.

\(^{18}\) 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 & s 48, 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.
Arrangements were then made to visit the Charity Commission's offices to review the public files of the 102 charities chosen. By law, these charities would have to have 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 wide experience in reading charity accounts) and a range of variables were noted in each case, as follows.

(a) Total income of charity as shown in the accounts (or expenditure if larger)

(b) Type of accounts: receipts & payment / accruals / mixed\textsuperscript{19}

(c) Subjective assessment of overall quality of accounts.\textsuperscript{20}

(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 independent examination report not before date of accounts being signed by the charity trustees; states that it is a report of an examination carried out under s43 of the Charities Act 1993 and in accordance with directions under s43(7)(b); includes at least the four minimum opinions required in all IE reports.

(f) Whether the scrutiny report was qualified.

(g) 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.

\textsuperscript{19} 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.

\textsuperscript{20} Variables (a) to (c) were recorded primarily for the purposes of broader study of charity accounting, and are only used peripherally in the independent examination study reported here.
On the basis of this data, in particular the contents of the independent examiners' reports (where present), it is possible to make a reasonably informed assessment of how far the regime is understood, and to gain some indication of those who are acting as IEs.

**FINDINGS**

The principal findings from this study of filed charity accounts were as follows.

Of the 102 charities selected for detailed study of the accounts, no meaningful assessment of independent examination was possible in sixteen cases, due to files not available and similar issues. This left 86 sets of accounts which could be studied in full, with recording of the variables listed above. All of these were accounts with year ends from 2001 to 2003 inclusive (in each case taking the latest accounts filed with the Commission).

**Type of Scrutiny**

In terms of the Charities Act requirements, all of these 86 charity accounts were eligible for independent examination, unless the charity had some other requirement for a full audit. The results for the type of scrutiny were as shown in Table II.
TABLE II:
FORMS OF ACCOUNTS SCRUTINY RECORDED IN PUBLISHED ACCOUNTS

<table>
<thead>
<tr>
<th>Form of Scrutiny</th>
<th>Number of Cases</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No form of external scrutiny at all (in breach of the Charities Act 1993).</td>
<td>7</td>
<td>8%</td>
</tr>
<tr>
<td>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.</td>
<td>15</td>
<td>17%</td>
</tr>
<tr>
<td>Independent examination of some kind in that the words &quot;independent examination&quot; or &quot;independent examiner&quot; were used in some kind of scrutiny report.</td>
<td>46</td>
<td>53%</td>
</tr>
<tr>
<td>Some form of external report which was neither an independent examination nor an audit.</td>
<td>18</td>
<td>21%</td>
</tr>
<tr>
<td>TOTALS</td>
<td>86</td>
<td>100%</td>
</tr>
</tbody>
</table>

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 above) which were included in the IE's report (potentially, eleven points could be given).

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21 It is conceivable that in one or two cases this might have been a 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) a condition of specific funding.

22 These were in breach of the Act. These cases 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.
Good practice, as advocated by formal guidance and by bodies such as ACIE (Charity Commission 2001; Auditing Practices Board 2002; Morgan 2004b) 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 the Regulations to be included in an IE's report\textsuperscript{23}. However, the requirement to state any relevant professional qualifications held by the IE allows for the possibility that in some cases the IE may have no qualifications to include, so it is not necessarily wrong to find this omitted. But the remaining nine points are undoubtedly essential to comply with the statutory framework\textsuperscript{24}.

Counting each of these points gives a potential score from 0 to 11 for each independent examination report observed, where any score below 9 would indicate that the IE had omitted at least some essential element.

Of course, the appearance of a complete independent examination report is no evidence that a through and competent independent examination has in fact taken place. There is anecdotal evidence of cases where the wording of IE reports has simply been copied from other sets of accounts or from the Charity Commissioners' guidance (2001) 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.

\textsuperscript{23} Charities (Accounts and Reports) Regulations 1995 - regulation 7.

### TABLE III: NUMBERS OF POINTS INCLUDED IN INDEPENDENT EXAMINATION REPORTS

<table>
<thead>
<tr>
<th>Number of Points Included</th>
<th>Number of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>All 11 points</td>
<td>10</td>
</tr>
<tr>
<td>10 points</td>
<td>12</td>
</tr>
<tr>
<td>9 points (minimum required by law)</td>
<td>13</td>
</tr>
<tr>
<td>8 points</td>
<td>5</td>
</tr>
<tr>
<td>5 - 7 points</td>
<td>4</td>
</tr>
<tr>
<td>3 - 4 points</td>
<td>2</td>
</tr>
<tr>
<td>2 or fewer points</td>
<td>0</td>
</tr>
<tr>
<td>MEAN NUMBER OF POINTS INCLUDED</td>
<td>9.1</td>
</tr>
<tr>
<td>TOTAL CASES</td>
<td>N = 46</td>
</tr>
</tbody>
</table>

### The Independent Examiners

Out of the 86 sets of accounts validly considered, and excluding the 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 - neither independent examination nor audit). These can be categorised as follows – in a way that enables us to gain some idea of how far IEs appear to be coming from a “civic engagement” perspective.

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 UK’s chartered accounting 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 gave an individual name followed by other qualifications (e.g. chartered bankers, or non-chartered accounting qualifications).

In eleven cases, an individual name was given without any professional qualifications.

**Qualified Independent Examination Reports**

The sample included two cases of IE’s reports with qualified wordings (4% of the independent examination cases) – i.e. cases where the IE expressed some reservation about the accounts upon which he/she was reporting. 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 assessment in variable (c). 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, a qualified IE report would arguably have been warranted in considerably more cases. But without access to the accounting records it impossible to quantify the number of additional cases which should have had qualified reports: for example an IE might have decided certain departures from the required presentation were not material.

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.

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25 Though they could in principle be accountants in professional practice under their own names, with no firm name used.

26 Charities (Accounts and Reports) Regulations 1995 - regulation 7(e)(iii).
Analysis and Implications

The results of this assessment enable us to make following assertions about the operation of the independent examination regime, firstly at a technical level and then in terms of civic engagement.

Technical Assessment

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. So the early suggestions that the independent examination regime would be insufficient to satisfy charity trustees and their funders seem to be dismissed by this study: only 17% of these charities had opted to have a full audit. (The remaining 29% of cases are explained by accounts submitted with no proper independent examination or audit - see Table II.) So, of the 61 cases (71%) which were at least attempting to use one of the forms of scrutiny permitted by the Act, there were 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 that only 71% of charities in the sample had a form of scrutiny (either audit or independent examination) which was even close to this requirement. The Charity Commission will no doubt wish to address this through its regulatory work; although pressure of resources means that compliance work is focused on the serious cases where charities require formal investigations (Lock 1998; Charity Commission 2004b).

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, 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 accounts27 - or, conversely, as many as 55% of charities in the

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27 This calculation is based on 65% which had filed returns x 98% of these which had submitted accounts x 71% which had an independent examination or audit. However, this is a “worst case” calculation, as it assumes that all of the charities which failed
IE range appear to have failed even to attempt to submit validly scrutinised accounts. These statistics are broadly in line with the Charity Commission's own research (Duck 2003).

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

Both of these results are considerably stronger than the earlier study (Morgan 2000; 2002c) which, in a smaller sample, found nineteen independent examinations and eight audits (a higher proportion choosing a full audit), and only six out of the nineteen 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.

**Assessment – Identity of IEs and Civic Engagement**

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 24 not based in firms, looking at the qualifications given, there is an approximately 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.

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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).
CONCLUSION

The Effectiveness of the Regime

From the explanation of the statutory regime, 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.

Whilst the IE is not expressing a full true and fair audit opinion, the seven areas of negative assurance, which can only be given after following the twelve stage programme of directions, mean that an independent examination falls not far short of what is required in an audit. Moreover, because the IE is specifically scrutinising charity accounts, many of the checks are very specific (for example in the attention given to restricted funds) and in these respects go well beyond the conventional duties of an auditor reporting on the accounts of an unlisted company.

Furthermore, for accruals accounts, an IE has to report on whether evidence has come to his or her attention indicating the accounts fail to comply with the Charities Act requirements: this requires the IE to have a good understanding of the Charities SORP and other accounting standards (particularly the FRSSE\(^2\))\(^8\). Also the IE must review the accounting policies adopted and consider their conformity with consistency and appropriateness (Charity Commission 2001, Direction 8).

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.

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\(^8\) However, in this respect the IE is specifically excluded from commenting on any non-compliance with the true and fair requirement – Reg 7(e)(iii) of the Charities (Accounts and Reports) Regulations 1995.
Policy Implications - UK

(a) Increasing the IE Threshold

The findings of this study suggest, therefore, that there is ample justification for increasing the upper income limit at which charities can have an independent examination to £500,000, as proposed by the Government (Home Office 2003, 2004a; House of Lords 2004). However, there is no doubt that to undertake an independent examination properly is a demanding process, and the study of accounts filed supports the view that some IEs may be issuing unqualified reports where this is not justified.

It is therefore reasonable to support the Government’s view that for charities in the new upper band of independent examination, from £250,000 to £500,000 income, the independent examiner should be required to have a recognised professional qualification.

However, in the Bill as tabled (House of Lords 2004, clause 27(5)) the initial proposed qualifications are limited to traditional qualified accountants and members other bodies whose members are eligible to be reporting accountants under company law. This includes accounting technicians, for example, but it will tend to exclude many independent examiners drawn from within the charity sector.

Earlier work (Morgan 2003) found a very wide range of individuals willing to undergo training with ACIE to become IEs, many coming from a background 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.

Many of those submitting evidence on the draft Bill argued for the inclusion of qualified full members of the Association of Charity Independent Examiners (Milburn 2004 Vols II & III; ACIE 2004c, 2004d) in the list of those qualifications which would be acceptable for independent examination of larger charities. The report of the Joint Parliamentary Scrutiny Committee reviewing the Draft Bill was sympathetic to this argument (Milburn 2004, Vol I para 118) and this is also supported by the National Council for Voluntary Organisations (NCVO 2005).
Because ACIE offers training for prospective IEs without requiring them to have an existing accountancy qualification, and then enables them to be assessed for Full Membership on the basis of actual charity accounts prepared and examined, the ACIE Full Membership qualification is potentially much more accessible to those with a background in the charity sector.

As this study shows, it is certainly not the case to date that most charities needing an independent examination have had to look to firms of accountants to find an independent examiner, nor is 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 (ACIE 2004d).

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 represent a broad cross section of individuals, some with other qualifications, and others with no qualification at all listed on their examination reports. It thus appears that both accountants and individuals with a range of backgrounds in the third sector are committing themselves to a role which would generally be seen as civic engagement, rather than a source of professional fees.

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.

An amendment to the Charities Bill was tabled by three members of the House of Lord to add members of the Association of Charity Independent Examiners to the list of qualifications in clause 27 (House of Lords 2005, amendment no 144), and when this was debated in the Committee Stage of the Bill, the Government was sympathetic and agreed to consider taking the further at the Report Stage (Bassam 2005). The final outcome remains to be seen.
(b) Wider Policy Implications at a UK Level

Whatever the commitment of individuals, the range of charity accounts in the present study which (on a subjective assessment) contained problems in their accounts demonstrates the need for more training and support for charities and their IEs - this includes professional accountants acting as IEs as well as others. In terms of requirements for qualifications, it might be argued that some specific knowledge of charity accounting might be made a requirement (as opposed to general accountancy experience).

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 year, including a recognition of the role that auditors and independent examiners play in this, which has received support from others (Charity Commission 2003c; ACIE 2003, Stoker 2004). But the problem of charities which fail to submit accounts, or where the accounts they do submit are neither audited nor independently examined, is an issue of general compliance with charity law: it is not a criticism of the independent examination regime. Moreover, independent examination 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.

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, and whilst the IE does not express a true and fair view, the remaining requirements are still considerable. There is no way the Charity Commission could directly investigate the financial affairs of hundreds of thousands of small to medium charities, and the reports of IEs are essential to the process.

Policy Implications – Europe-wide

The increasing emphasis on accountability of the third sector is creating pressures for greater regulation in many European counties (Evers & Laville 2004). Such regulatory pressure takes various forms, some of which can lead to excessive state intervention in the affairs of not-for-profit organisations.
The model of the independent examiner, as someone whose natural home is with the third sector, but who takes on a regulatory task as a matter of civic engagement, may well be suitable for consideration in other contexts.

Informal communications with the author indicates that at least two European countries outside the UK are interested in developing such regimes – although the very different systems of charity/non-profit law create considerable barriers. With new EU regime allowing for a common European structure for public companies - the Societas Europea (SE) finally implemented in 2004 (European Commission 2001), it is to be hoped that the common legal forms for third sector organisations such as the European Cooperative Society (SCE) (European Commission 2003) may soon be a reality. At present, the SCE Statute states that the accounting and auditing requirements of an SCE are governed by the Member State where it has its administrative office, but, if in the future these arrangements were harmonised, there would be considerable scope for extending concepts such as independent examination at a European level.

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**ANNEX**

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**Author Biographical Note**

Dr Gareth G Morgan is Director of the Centre for Voluntary Sector Research at Sheffield Hallam University, UK - an interdisciplinary group linking four departments and faculties. His own primary research interest is in charity accounting and regulation, with particular reference to its impact on small to medium voluntary organisations. He has published various papers in this area and is the author of an introductory book on the subject. He has presented work on charity regulation both in the UK and internationally, at academic conferences and at NGO practitioner events. He regularly undertakes consultancy work on charity accounting and independent examination and he was active in helping to establish the Association of Charity Independent Examiners. He has served on a range of consultative bodies concerned with the development of charity law in the UK.

**SUMMARY**

This paper assesses a legal regime in the UK which allows charitable organisations below a certain size to have an independent examination of their accounts. Although covering slightly less than a full audit, the independent examination is a demanding statutory process, requiring assurance under at least four headings – but it can potentially be carried out by an individual with good financial or accounting experience who has a background in the third sector: the independent examiner is not necessarily a professional accountant. The regime thus offers the potential for the sector to undertaken a measure of self-regulation in this area.
Independent examiners are thus engaged in an interesting form of civic engagement: that of supporting the regulation of the third sector. The paper investigates the effectiveness of this, using a combination of research methods, in particular a study of 700 registered charities, including analysis of approximately 100 sets of accounts filed with the UK Charity Commission where independent examination was potentially possible.

The paper also explores a proposal to increase the size of charities eligible for the regime, subject to a requirement for the independent examiner in these cases to hold a relevant professional qualification, and assesses the implications of this from the civic engagement perspective.

The conclusion is that the third sector should welcome initiatives such as the independent examination regime, which permit self-regulation. However, to achieve the levels of compliance expected, especially if independent examiners are to be required to hold specific qualifications, means significant resources are needed to support those who are to undertake such self-regulatory tasks. However, the experience of the UK indicates that a wide range of individuals are willing to undertake independent examining as a form of civic engagement, which may have valuable policy implications for other countries.