

BEIS Restoring Trust in Audit and Corporate Governance consultation

JULY 2021

About Charity Finance Group

Charity Finance Group (CFG) is the charity that works to improve the financial leadership of charities, promote best practice, inspire change and help organisations to make the most of their funds so they can deliver the biggest possible impact for the communities and beneficiaries they serve. CFG has over 1450 members and collectively they manage over £21 billion in charitable funds – around a third of the entire charity sector’s income.

About our response

This response is submitted by CFG on behalf of its members, and endorsed by a number of individual charities. We held two roundtables with member and non-member charities and corporate members to exchange and gather views in May and June 2021. The draft response was refined through input of and consultation with members, and is supported and endorsed by 16 named organisations (see Annex 1).

This response will not address the consultation questions exhaustively in so far as the majority of the questions and reforms are not aimed at charities and not for profit entities – such as Directors’ accountability for dividends and capital maintenance - but is instead intended to present broad principles and address those areas of most relevance to the charity and not for profit sector.

Key Points

The main areas of focus in this submission are;

- Charity context, applicability and proportionality
- Resetting the scope of regulation and the definition of PIE
- New Corporate Reporting, specifically the Resilience Statement
- Enforcement Against Directors of PIEs

1. Overall remarks

- 1.1 CFG has long advocated that all regulatory or legal changes should be assessed through the lens of impact on charity and social change organisations to ensure that the balance between benefit and burden is proportionate. It is not enough to simply identify that a policy can technically be applied to the mechanics of accounting or operation within charities. Regulatory and legal changes should ensure that whatever the risk being mitigated or harm prevented, such a harm or risk exists within the charity sector before being introduced. This is a fundamental point because any resource being used to meet compliance and regulatory obligations is resource that cannot be used for furthering charitable activity. Of course, the two positions are not mutually exclusive; compliance can also further the delivery of public benefit but the starting point, in our view, should always be whether the balance between burden and benefit is proportionate and meaningfully addresses the policy objectives being pursued by those seeking to introduce the change.
- 1.2 CFG welcomes the opportunity to contribute to this important debate and represent our charity member interests in the far-reaching reforms proposed in the consultation. There will be a range of views across the charity sector and within the audit professionals who deliver services to, and audit the work of, large charities as to where the balance lies between increasing regulatory burden and delivering public benefit in the context of charity. We have sought to engage with charities and corporate partners in forming our submission and have taken into account a wide range of opinions. **It is our view that the reforms to extend the Public Interest Entity (PIE) definition to a greater proportion of charities, as currently drafted, do not strike the right balance, do not achieve the intended policy aims in the context of charity and therefore may have unintended consequences.** However, we are keen to work with Government to strike the appropriate balance and find the most appropriate mechanism for public accountability for the largest charities.

Policy driver

- 1.3 The Secretary of State in his Foreword to the consultation document clearly sets out the impetus for the reforms to reinforce the UK's position and attractiveness to investors and financial markets in the wake of large corporate failures, to "*enable the UK to remain a premier global centre for investment*".

Whilst we are supportive of the policy objective as it relates to private enterprise it is important to bear in mind the following;

- i) charities do not routinely operate in or are subject to 'market forces' in the same way as corporate entities, often operating where a market has failed or where market conditions lead to social groups being excluded or disadvantaged.

- ii) investment in the not for profit space is principally for social and not economic return, with the behavioural responses to fiscal distress attracting a quite different response from stakeholders (investors, consumers, suppliers etc. in a commercial context and beneficiaries, donors, service users and funders in a not for profit context); in the context of charity, stakeholders are more likely to 'invest' in a cause which is undergoing financial challenge whereas in the private context such circumstances are more likely to prompt the withdrawal of support.
- iii) there have been no comparable economic failures in charities in the over £100m income bracket
- iv) the market for and supply of audit services to the charity and non-profit sector is more diverse than that in the commercial sector

These points should not lead to complacency on the part of the sector, nor should the current proposals be dismissed out of hand. The ambition to increase trust, accountability and transparency and the recognition of their importance to delivery of public benefit and future growth is one shared by, and equally important to, the charity and non-profit sector. However, it is important to consider the differences between the sectors and acknowledge the extent and efficacy of the oversight, scrutiny and statutory regulation that already exist for the not for profit sector and its role in ensuring wider public trust and relevant stakeholder confidence.

- 1.4 Many of the proposed reforms in the White Paper are not immediately aimed at, nor designed for the charity and not for profit sector, such as Directors' accountability for dividends and capital maintenance. We urge government to shift the focus from what can be technically applicable to not for profit organisations being disapplied if there is demonstrable consequential harm to one of only increasing regulatory burden where there is a clear case for so doing.
- 1.5 In this response, we seek to identify those proposals in the consultation which may be appropriate and achieve the desired policy outcome in the charity context and also identify where there may be unintended consequences of a proposed approach. We agree with the sentiments for increasing transparency, accountability and the quality of audit and therefore are not suggesting that there should be a blanket exemption for charities and not for profits from any reform of audit and corporate governance. However, we strongly believe that the case for extending PIE, a regime devised for the corporate world, to charities is not made and furthermore believe that there are alternative mechanisms for charities which would be better suited to increase the public accountability of the largest charities. We urge the government to continue to engage with the sector and its representative bodies to design legislation which is appropriate and proportionate to the charity sector. CFG remains committed to assisting government in designing appropriate legislation that achieves its purpose, avoiding the creation of additional burden and cost with minimal impact and aiming to increase trust, transparency and confidence in our sector.

Current charity regulation

- 1.6 The sector is highly regulated, including by the Information Commissioner's Office, the Fundraising Regulator and HM Revenue and Customs (HMRC), and the legal framework is underpinned by the Charities Act 2011, supplemented by regulations and guidance issued by the Charity Regulators. For example, the Charity Commission in England and Wales has a significant serious incident reporting regime¹ that requires auditors and charity Trustees to make reports to the regulator on matters that go beyond those required by the regulatory reporting requirements for the private sector, and which is a statutory requirement on auditors as set out in the Charities Act 2011. In contrast to the reporting regime for corporate failure, it is a statutory requirement for auditors of charity accounts to report to the regulator when they plan to issue a modified audit opinion including concerns around Going Concern. HMRC are also an active regulator through the Finance Act 2010 definition for tax purposes of charities entitled to UK tax reliefs, which includes a requirement for the organisation to satisfy the management condition of a 'fit and proper persons' test' for charity Trustees.
- 1.7 There are also charities who are not regulated by the Charity Commission in England and Wales, such as universities and housing corporations many of whom are already classed as PIEs under the existing definition due to listed debt. We urge BEIS to work with the Charity Regulators and other sector regulators to avoid additional and potentially conflicting regulatory burdens, which bring complexity and added compliance burden with minimal public benefit.

2. Consultation Themes

2.1 The Public Interest Entity Definition (Ref Questions 2, 6, 7, 10, 11, 29)

- 2.1.1 There are some charities who are already classified as Public Interest Entities (PIEs) under the existing regulation (such as those charities in the housing sector who have listed debt on their balance sheet), others who may become classified as PIEs under the proposed definitions due to their size (Options 1 and 2 as set out on pg. 33 of the consultation document) and yet others who would fall under the proposed definition for third sector entities with incoming resources exceeding £100m.

It is recognised that for charities that interact with regulated markets the current definition of being classified as PIEs is appropriate. However, we do not support extending this on a purely size based criteria. There remain concerns around the extension of this regime to a wider proportion of charities

¹ <https://www.gov.uk/guidance/how-to-report-a-serious-incident-in-your-charity>

without a clearer understanding of how the proposals for requirements under this new definition might apply to charities, as opposed to commercial entities. There are concerns about applicability, proportionality, and cost of compliance set against any potential public benefit gain and the implications for charity Trustee responsibilities, existing governance structures and the existing regulatory regime. Increases in costs for compliance in the charity context come out of funds for the purposes of addressing beneficiary need and delivering public benefit rather than from profits that are to be distributed for private benefit.

2.1.2 The [Regulatory Impact Assessment](#) for the White Paper states that the Government's aim in expanding the PIE definition is broadly to ensure that:

- there is a clear articulation of the public interest in any group of entities being added to scope, for example, to provide increased investor protection, where their purpose has public benefit or in recognition of wider economic significance;
- the impact is proportionate, i.e. the benefit of such entities becoming PIEs merits the extra regulation required of them; and
- as far as possible, the definition is aligned with existing thresholds which are used to determine the entities in scope of audit, corporate reporting and corporate governance requirements.

The Government considers this to be a proportionate approach which will ensure that companies with greatest public importance are held to account in the public interest, whether traded or not.

The extension of the PIE regime to charities due to their size, and especially to those meeting the classification for any third sector organisation with incoming resources in excess of £100m, requires more detailed consideration, including a full and proper targeted impact assessment for the Third Sector to ensure that the government's aims are indeed applicable, proportionate and align with existing thresholds for reporting and governance.

2.1.3 The International Ethics Standards Board for Accountants ([IESBA](#)) have recently concluded a consultation on an international standard for a definition of PIEs and recommended that the term 'listed entity' should be replaced by 'publicly traded entity'. IESBA is of the view that entities whose financial instruments are only listed or issued to the public with no trading do not necessarily attract significant public interest in their financial condition and that charities are not captured by their definition of PIE.²

Until 2016, the Financial Reporting Council (FRC) inspected the audits of charities with income over £100m and then subsequently removed them from scrutiny as a deregulatory measure. We are keen to understand what

² <https://www.ethicsboard.org/news-events/2021-01/iesba-proposes-holistic-approach-defining-public-interest-entity>

incidents have occurred in the charity context since 2016 that would warrant the reversal of removing red tape and reducing compliance burden in the charity space and whether the extension of the definition of PIE to such entities would address those concerns.

- 2.1.4 It is undeniable that the purpose of all charities is to deliver public benefit and that in the case of some of the largest charities they are of great public importance, however they are already subject to scrutiny and regulation through the Charity Regulators (Charity Commission for England and Wales, Office of the Scottish Charity Regulator, The Charity Regulator for Northern Ireland) and must apply the Charities Statement of Recommended Practice (SORP), intended to assist in the application of Financial Reporting Standard (FRS) 102 in a charity context (*See also section 1.5 above*). It is not evident if the impact of the extra regulation required under the proposals in this White Paper will be proportionate in the majority of cases. The issue of tiered reporting for charities is being considered in the current review of the charities SORP, albeit focusing more on the requirements for smaller charities, rather than for the very largest.
- 2.1.5 Charities and not for profit organisations may be captured both by the new proposed extended definition of PIEs by size as set out in ‘Option1’ and ‘Option 2’ on pg. 33 of the consultation document³ and by the proposed definition for third sector entities. We seek confirmation of the interpretation that is applied to turnover with the standard PIE definition in a charity context. We assume that turnover is intended to comprise of ‘sales and goods and services’ as turnover is defined in the Companies Act, and not as total incoming resources, which would include voluntary income.
- 2.1.6 According to the latest figures⁴ based only on those charities regulated by the Charity Commission of England and Wales, 7%⁵ of the charity sector as regulated by the Charity Commission (equivalent to c 11,700 charities) employ 500 employees or more, though very few will also meet the threshold of having a turnover of more than £500 million. There are currently 56 charities registered with the Charity Commission who meet the criteria for incoming resources exceeding £100m⁶, and 84 charities if a wider definition is used⁷. It is noted that the Third Sector comprises of more entities than those regulated by the Charity Commission for England and Wales.

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970673/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf

4 NCVO Almanac 2020 <https://data.ncvo.org.uk/>

5 Table F2, NCVO Almanac 2020

6 Table A1, NCVO Almanac 2020

7 Using Charity Financials: <https://www.charityfinancials.com> (excluding Housing Associations and Higher Education organisations)

- 2.1.7 We do not believe that it is appropriate nor proportionate that these proposals, which are not primarily aimed at charities and not designed for charities, would have lower thresholds for charities than other entities. As discussed in 2.1.4, charities are already subject to regulation by the Charity Regulators for the purposes of delivery of public benefit. Our strongly held view is that if these reforms are to apply to charities at all, then they should at least be applicable on the same threshold as other types of entity.
- 2.1.8 Using size to define which charities and not for profit entities are in and out of scope may be a blunt instrument and not provide accurate reflection of impact. Whilst it may not be unique that there is great variety in the context and operating models of large charities, it is important to ensure that benefit arises from inclusion within an expanded definition. It would be helpful to work together to identify those elements which would be more effective in the charity space; whether by business model/fundraising sources, workforce/volunteers or a combination of factors, before extending the definition to include such a broad spectrum of entities.
- 2.1.9 It is necessary to have a clear view of what tangible benefit would be achieved by increasing the number of charities classified as PIEs and have them report to the Audit, Reporting and Governance Authority (ARGA) over the Charity Regulators and whether there may be alternatives, such as incorporating the additional reporting requirements into a bespoke regime for the largest charities. CFG urge against there being a double regulatory burden in place for both ARGA and the Charity Regulators which would potentially add to compliance burden, costs and complexity.
- 2.1.10 CFG agree that the Government should provide time for companies and all affected entities to prepare for the introduction of a new definition of PIE and that a phased introduction for any new definition be pursued.

2.2 New Corporate Reporting – Resilience Statement (Ref Questions 19, 21)

- 2.2.1 We welcome the proposal to introduce a statutory requirement to publish an annual Resilience Statement, consolidating and building on the existing going concern and agree that this has wide applicability, especially following the experience of Covid-19 which has heightened the need for entities to consider and explain how they are preparing to cope with liquidity, solvency and operational risks during a prolonged period of uncertainty.
- 2.2.2 The Resilience Statement could be built into the Reserves statement that charities are already required to prepare as part of the SORP. Charities are not currently required to produce viability statements, though it is a statutory requirement for auditors to report to the regulator if they intend to issue a modified audit opinion, including any concerns about Going Concern. However, this will potentially contribute to increasing the amount of information that is required in the Trustees Annual Report and, contrary to recent

discussions in the charity sector regarding how to demonstrate impact and increase transparency to increase public trust, to focus more on financial reporting rather than impact.

- 2.2.3 In common with other sector specific SORPs, should a need be identified for additional reporting, requirements can be modified and incorporated into sector specific regimes, however, it is important to first ensure that the requirement for additional reporting meets an identified need and is proportionate to the increase in regulatory burden and cost of compliance. CFG looks forward to working with government to further develop this proposal for charities and not for profit entities.

2.3 Enforcement Against Directors and implications for Governance Arrangements (Ref Questions 29, 34)

- 2.3.1 The implications of charities becoming PIEs rest heavily on existing governance arrangements and duties of charity Trustees. The overwhelming majority of charities are governed by unremunerated, volunteer Trustees who must ensure that their charity meets its obligations under charity law and regulation, whilst achieving the charity's purpose and its charitable objectives. The Charity Commission, as the Charity Regulators, regulates the delivery of the charitable purpose and meeting of charitable objectives through appropriate governance by the charity Trustees. The management (financial and otherwise) and responsibilities of charity Trustees is the main focus of the Charity Regulators' oversight.
- 2.3.2 The operating context for charity trustees sitting on Charity Boards differs significantly from that of Corporate Boards. Charity Boards are non-executive and there is no personal financial gain for charity Trustees, though they accept many responsibilities for the governance of their charities when they take on their role and are not to be considered any less competent than those leading similar sized public interest commercial entities. A number of proposals in the White Paper refer to 'shareholder approval', which does not apply in a charity context. The equivalent would typically be the charity Trustees, who are the same group that are charged with governance of the charity. The Charity SORP and Charity Commission governance framework already stipulate reporting and set expected practice in relation to the deployment of internal controls, and therefore additional measures may not be as necessary as they might be for large corporate entities.
- 2.3.3 The proposed regime set out in the White Paper will give the regulator new powers to take civil enforcement action against PIE directors in relation to breaches of existing PIE directors' duties relating to corporate reporting and audit (and any new duties which are introduced further to the consultation). CFG's view is that the personal liability potentially inferred upon charity

Trustees as a result of the PIE classifications are largely unworkable and inappropriate in the charity context.

- 2.3.4 Charity Trustees should be in no worse a position than non-executive directors of commercial entities where responsibility is shared with executive directors, and unless there are significant changes to charity governance arrangements (such as introducing paid charity Trustees and changes to charity governing documents) these changes are unworkable and inappropriate. There is a risk that increasing the risks involved in an unremunerated position would further reduce the pool of candidates for such roles. The impact on diversity and inclusion of charity Trustee boards needs to be further examined and CFG recommends that Trustee views are sought directly on this issue and encourage engagement with representative bodies.
- 2.3.5 Charities and Trustees would need to consider their current governance arrangements and whether those coming under the PIE definition may need to revise both how they are structured in order to meet the proposed obligations, such as making changes to their governing documents and in their reporting arrangements, and the frequency of meeting. The additional time burden on voluntary Trustees must be considered and balanced to ensure that benefits are genuinely delivered and not just additional cost.
- 2.3.6 CFG recommends therefore that the proposed enforcement on Directors in the charity context will not achieve the intended aim of the legislation and is not applicable nor proportionate as currently envisioned.

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Annex 1 – Organisations Endorsing this Submission

British Heart Foundation www.bhf.org.uk

Bond www.bond.org.uk

Christian Aid www.christianaid.org.uk

Citizens Advice www.citizensadvice.org.uk

Crowe UK LLP www.crowe.com/uk

Great Ormond Street Hospital Charity www.gosh.org

National Council for Voluntary Organisations www.ncvo.org.uk

National Trust www.nationaltrust.org.uk

Oxfam www.oxfam.org.uk

Pilotlight www.pilotlight.org.uk

Royal British Legion www.britishlegion.org.uk

Royal National Lifeboat Institution www.rnli.org

Royal Society for the Protection of Birds www.rspb.org.uk

Save the Children Fund www.savethechildren.org.uk

Save the Children International www.savethechildren.net

Sightsavers www.sightsavers.org