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Incidence and perceptions of “qualified” accounts filed by small charities

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ABSTRACT

Charities filing accounts with the Charity Commission for England and Wales have been asked since 2014 whether their accounts are qualified. It was found that 96% of charities (£100k-250k income) stating that their accounts were qualified had mis-answered the question. This was explored further with charity personnel and funders supporting small charities: the notion of qualified accounts was found to be misunderstood both by operational charities and by their funders.

This raises issues regarding use of data on the Charity Commission’s Register and for charity regulation, as the Commission indicates that qualified reports are a trigger for possible regulatory investigation.

HIGHLIGHTS:

- 96% of charities, stating to the regulator they have qualified accounts, do not
- Term “qualified accounts” misunderstood by small charities and funders
- Funders seek charity accounting compliance information from regulator
- Regulator’s website displays inaccurate information on charities’ qualified accounts
- Funders unlikely to dismiss a small charity solely on basis of qualified accounts

Key Words: England & Wales charities; charity accounting, qualified accounts, independent examiner’s report; charity regulation.

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1. Introduction

In many jurisdictions, a key means by which charities demonstrate accountability is by registration with a charity regulator and a requirement to file annual accounts that have been independently scrutinised, with the accounts then made publicly available by the regulator (e.g. Lehman 2007, Ryan et al. 2014).

We present findings from a study that analysed a representative sample of registered charities in England and Wales with income in the range £100k to £250k, which reported to the Charity Commission that their accounts had been “qualified”. The study examines the true incidence of qualified accounts, or more accurately qualified reports from an independent examiner or auditor (as discussed below) in this sample. We assess the extent to which qualified reports have been mis-reported by charities in their returns to the Commission. We also explore the perceptions of charities themselves to having qualified accounts and consider the attitudes of grant-making charities to supporting charities with qualified accounts (or which appeared to be so) in terms of the possible impact on funding decisions.

1.1 Filing of charity accounts: England and Wales

In England and Wales (E&W) registered charities with annual incomes over £10k are required to file an annual return with the Charity Commission and those with income over £25k¹ are required to submit a set of year-end financial statements comprising three elements; a narrative trustees annual report (TAR), annual accounts and an external scrutiny report on the accounts from an auditor or independent examiner. (It is common practice for charities to combine the three elements into a single document referred to commonly as “the accounts”) Most charities submit their accounts by uploading PDF copies through the Commission’s online portal, although filing in paper form is permitted. The Commission makes these documents available for inspection online. The statutory scrutiny framework for this lies in the Charities Act 2011 and supporting regulations.²

¹ The £25k filing threshold does not apply to charities constituted as charitable incorporated organisations (CIOs): all CIOs must file their accounts with the Commission regardless of income.

² Charities Act 2011 Part 8 (sections 130-176) with the details in the Charities (Accounts and Reports) Regulations 2008. The 2008 Regulations specify the contents of the accounts, the TAR, and the duties of auditors and independent examiners.

The scrutiny framework operates at two levels: charities with income up to £1 million³ can generally have an independent examination, a lower level of independent scrutiny than a full audit, which is required by larger charities over this threshold (Charity Commission 2016a, Morgan 2011a). Only 4% of registered charities have income in excess of £1 million (Charity Commission 2017a), therefore independent examination (IE) is the predominant scrutiny framework in charity accounting. Therefore, it is primarily the issue of qualified accounts under the IE framework that will be considered in this paper, rather than a full audit.

When charities submitted their accounts online for their 2014 Annual Return⁴ (AR2014), the Charity Commission introduced the question “Are your accounts qualified?” The charity’s self-reported accounts status as to whether or not the accounts were qualified, is displayed on the Register of Charities on the Commission’s website, without verification. These records can be viewed by anyone including funders and donors.

The authors were aware, prior to this study, of charities that had stated when submitting their accounts to the Charity Commission, that they had qualified accounts, when in fact, their examiners had not issued qualified independent examination reports (IERs). Anecdotally we heard of charity staff and trustees who understood the question to mean: “Had their accounts been scrutinised by a qualified examiner?”⁵ This indicated a measure of confusion on the concept “qualified” IERs.

62% of registered charities have income of less than £25k (Charity Commission 2017a) and therefore are below the minimum £25k threshold for IE and for submitting accounts to the Charity Commission, so do not make a declaration to the Charity Commission about whether their accounts were qualified or not. Therefore, these charities were irrelevant to investigate in this study. The present study focuses on charities with incomes between £100k-£250k which represents over a quarter of charities required to have an IE and submit accounts to the Charity Commission.

³ An audit is also required where the charity’s gross income exceeds £250,000 and its gross assets exceed £3.26 million.

⁴ This covers all charity financial reporting periods that ended in the 2014 calendar year.

⁵ This is particularly relevant, because there are two forms of IE: up to £250k income a ‘lay’ independent examiner is permitted; above that threshold the independent examiner must be professionally qualified (Charities Act 2011, s.145). However, by focusing in this study on charities not over £250k income, none were required by law to use a professionally qualified independent examiner.

1.2 Conceptual understandings and definitions

The word “qualified” has several dictionary meanings including officially recognized, being entitled, eligible to compete, attributing a quality to something. But it can also mean not complete or absolute, which provides sense to the accounting term. Weetman (2017) noted that the term “qualified” in accounting legislation first appears in the 1929 Companies Act “requiring that a qualification mentioned in the auditor's report on a subsidiary must be mentioned in the report on the parent company” and she suggested that the term is likely to have emerged out of case law on group accounts.

A concept can be regarded as a linguistic device used to signify phenomena that helps us to communicate (Gill 2010), but there cannot be certainty that there is shared understanding of any phenomena, without operationalizing the concept to give it a precise definition. One can never assume that there can be shared understanding. Indeed taking a sociolinguistic perspective (Belkaoui 1980, Evans 2004), researchers have found that there is no consensus on the meaning and interpretation of key accounting terms even within different professional affiliations within the accountancy profession. The concept of a “qualified IER” is abstract until it has indicators attached that define in what circumstances a report is qualified.

Johnson and Duberley argue that taking the subjectivist argument to an extreme is problematic due to the “consequent eradication of any check upon our knowledge claims” (2000, p67). They suggest this position is moderated by the consensus theory of truth whereby truth is a socially constructed agreement between those that share a paradigm or frame of reference. This pragmatist position more comfortably allows acceptance of the definition of a “qualified” IER, as, whilst socially constructed, it is one that has a degree of agreement for the time being, in the context of (charity) accounting. See section 2.3 below for details of the IE regime.

It is worth noting that in some jurisdictions, charity accounts routinely receive qualified audit reports on the grounds of uncertainty of recorded income. But in the UK, the Financial Reporting Council’s guidance (2017, paras. 110-114) requires charity audit procedures to consider the systems for income recording, and a qualified audit report is only implied if concerns arise. Similarly in an IE, a review of the accounting records for income is required (Charity Commission 2017b, Direction 5) but a qualified IER would only be needed on this issue if the examiner considered the records to be materially incomplete.

1.3 Research aims

The study reported in this paper had two aims. The first aim was quantitative; to establish how accurate charity self-reporting to the Charity Commission has been among charities with income of between £100k-£250k, by establishing what proportion of charities in this income band, that stated they had “qualified” accounts, *actually* had a qualified IER or audit report.

The second aim was to explore perceptions of this issue, firstly from key personnel in charities that had qualified accounts regarding what they believed the impact of having “qualified” accounts was (or was likely to be) on the charity and secondly from funders (personnel within small grant-making charities) that use charity accounts and/or the Charity Commission website in their grant assessment process. The study explored how grant-funders regarded charities with “qualified” accounts, or those labelled as such by the regulator and how this impacted on funding decisions. (It is acknowledged that charities in the £100k to £250K income range may receive income from a wide range of sources including individual donations, grants from other charities, trading activities and statutory services, but the specific focus of this second aim was limited to perceptions regarding grant funding from other charities.) The study was designed in two stages corresponding to the two aims, as set out in sections 3 and 4.

Arising from these aims, the overall implications of qualified accounts in relation to accountability and regulation of the voluntary sector in England and Wales are considered. This is in light of the Charity Commission considering that having a qualified IER/audit report is a potential indicator of charity mismanagement and may increase the likelihood of regulatory action (Shawcross, 2013). Subsequent to the fieldwork reported in this paper, the regulatory interest in qualified accounts has been recently re-affirmed with revised guidance from UK charity regulators on reporting matters of material significance by auditors and IEs (Charity Commission, OSCAR & CCNI 2017). A qualified IER (or any form of modification or emphasis of matter paragraph) is now regarded as a “matter of material significance” to the regulator. Auditors and independent examiners now have a mandatory duty to inform the relevant charity regulator whenever they give a qualified report.

2. Literature Review

2.1 Charity Accountability Considerations

There are numerous dimensions of non-profit accountability, covering much more than just questions of governance or financial reporting practices (Dhanani 2009, Prakash and Gugerty 2010, Coule 2015). Nevertheless, accounting and reporting, “are necessary to maintain and build confidence in the charity sector as a basis for promoting both charitable giving and charitable activity” (Connolly and Hyndman 2013a, p260) and vital for transparency (Burger and Owens 2010). The growth of the charity sector, competition for resources, the sector’s role in delivering public services in the UK, as well as the sector’s need to gain legitimacy with stakeholders has led to an evolutionary growth in specific rules on charity financial reporting and financial regulation by the Charity Commission (Cordery and Baskerville 2007).

Stakeholder accountability is articulated in the current standard for charity financial reporting in the UK, known as the Charities SORP.⁶ It states the objective of the TAR and accounts is “to provide information about a charity’s financial performance and financial position that will be useful to a wide range of stakeholders in assessing the trustees’ stewardship and management of charitable funds ...”. (Charity Commission and OSCR 2014, Introduction para. 24).

It is debateable whether not-for-profit organisations genuinely believe that they have a responsibility to create trust by accounting to stakeholders through public discourse (Dhanani and Connolly 2012, Strickland and Vaughan 2008), or whether organisations require support of “definitive” stakeholders to gain resources in order to survive (Connolly and Hyndman 2013b). However, both interpretations of these stakeholder models support the notion that good accounting means disclosing information that meets stakeholder need.

⁶ The “SORP” refers to *Accounting and Reporting by Charities: Statement of Recommended Practice* – the standard that must be applied by charities preparing their accounts on an accruals basis. The version most widely applicable to smaller charities at the time of the study was SORP 2015 FRSSE (Charity Commission and OSCR 2014). Not all charities in this study followed the SORP as charities up to £250k income, which are not structured as companies may elect to prepare receipts and payments (R&P) (cash-based) account. Nevertheless, under the regulations, the possibility of a qualified IER applies to both R&P and SORP-based charity accounts.

2.2 Funder use of formal financial reports

Studies have shown that charity accounts often fail to meet stakeholder need, particularly donor/funder need, due to both the “information gap” between what information the charities provide (financial information) and what funders want (performance-related disclosures) (Hyndman 1991; Connolly and Hyndman 2013b) and due to the ability of stakeholders to engage with the information presented. It has been suggested that grant funders may undertake limited analysis of financial statements sent to them due to lacking the technical skills to read the financial information presented (Jiaying Huang and Hooper 2011). Furthermore, funders can deploy other values entirely when making funding decisions, ignoring all but the most basic financial information. For example they may be personally motivated by the cause or may perceive an applicant charity to be “inherently good” (Connolly and Hyndman 2013b, p962) or to be doing good things (Jiaying Huang and Hooper 2011).

Paradoxically, Connolly and Hyndman (2013a; 2013b) found that whilst funders find the audited financial information the least useful type of disclosure, they also regarded the fact that the accounts were independently scrutinised as critically important, signalling independent assurance from the auditor as evidence that the charity was complying with its responsibilities. Small donors in particular, trusted that others did the scrutinizing, so didn't undertake any scrutiny of financial information themselves.

Agency theory offers a traditional justification for independent scrutiny of accounts, where a triangle exists between the “owner”, “steward” and “auditor” (Pianca and Dawes 2009). An objective opinion on the financial statements is a deterrent to keep managerial behaviour in check and helps to address the information asymmetry between preparers and users of accounts by ensuring access to independently verified financial information. The “information hypothesis” (Gray, Manson and Crawford 2015) suggests that having an independent expert opinion on the financial statements gives them more value in the eyes of third parties. In the context of charities, as trustees in all but the smallest charities delegate the finance function to staff, independent scrutiny provides reassurance and accountability to the trustees but also provides increased public confidence to wider stakeholders (Morgan 2017). The regulator supports such accountability by mandating disclosure and fulfilling a monitoring role (Cordery and Baskerville 2007).

2.3 The Independent Examiner's Report

For charities in the scope of this research, the relevant level of account scrutiny is the independent examination. The Charity Commission provides a mandatory procedural framework⁷ of directions that independent examiners must follow (Charity Commission 2017b). The final direction is the completion of an IER. The IER, which is addressed to the charity's trustees, is prepared under regulation 31 of the Charities (Accounts and Reports) Regulations 2008. The examiner is required to provide a statement on up to seven specific matters, as shown in Table 1.

<p><i>The examiner confirms whether or not anything has come to their attention that suggests:</i></p> <ul style="list-style-type: none">• <i>Sufficient accounting records have not been kept</i>• <i>The accounts do not agree with the records</i>• <i>For accrual accounting, whether they fail to comply with relevant accounting requirements under the 2008 Regulations (for charitable companies, with section 396 of the Companies Act 2006), or are not consistent with the applicable SORP</i>• <i>Any matter which the examiner believes should be drawn to the attention of the reader to gain a proper understanding of the accounts</i> <p><i>Matters that the examiner must report include:</i></p> <ul style="list-style-type: none">• <i>Material expenditure or action contrary to charities purpose</i>• <i>Failure by trustees to provide information and explanations reasonable required by the examiner</i>• <i>Evidence that accounts prepared on an accruals basis are materially inconsistent with the Trustees Annual Report (Directors' Report for charitable companies).</i>

Table 1: Reporting Duties of the Independent Examiner. Simplified from CC32 Independent Examination of Charity Accounts: Examiners' Guide (Charity Commission 2017b)

An independent examiner's unqualified report provides a negative assurance on the specific matters detailed in the first four points in Table 1 (indicating that *no material issue* has come to the examiner's attention to suggest a concern). Comments on the final three points in Table 1 are needed only when something of relevance comes to the examiner's attention (necessarily amounting to a qualified report). The examiner is not offering an opinion as to whether the accounts provide a "true and fair view" (which is, itself, a highly contested term) as only a full audit process can provide such an opinion (Pianca and Dawes 2009) but is still offering opinions on these seven issues.

⁷ The mandatory nature of the directions derives from Charities Act 2011, s.145(5)(b). Ten directions were applicable to accounts filed in 2014, but the latest version expands this to 13 directions.

In previous work, Morgan found that the IE framework provides “a very comprehensive scrutiny, that meets the International Framework for Assurance Engagements (IFAC 2015) definition of a “limited assurance engagement” and, being charity specific, potentially exceeds the “conventional duties of an auditor reporting on the accounts of a small business” (2011a, p190).

The IE framework is critical in maintaining standards in charity accounting as independent examiners can encourage corrective amendments to accounts prior to completion of the examination. Substantial issues of concern raised by the independent examiner /auditor to the trustees as part of the external scrutiny process encourages self-reporting of charities to the regulator (Breen 2013). Furthermore, the statutory duty for independent examiners to inform the regulator if they become aware of a matter of “material significance” in the course of their examination, as defined by the specified list of circumstances specified by the regulator (Charity Commission, OSCR & CCNI 2017), motivates charities to ensure appropriate use of funds (Morgan 2011a). Morgan suggests the IE regime is critical in maintaining accounting standards and argues, “Where charity accounts have been properly scrutinised by a competent auditor or independent examiner who has given an unqualified report on the accounts, a higher level of confidence can be attached to their content” (2011b, p218).

The IE framework may be considered rigorous but there are problems with its application and enforcement of standards. In one study of over 1400 sets of charity accounts, Morgan and Fletcher (2011, p26) identified 9.7% of charities (income above £25k) with no scrutiny report of any kind and 4.5% had scrutiny reports that were not compliant with the 2008 Regulations. The Charity Commission reviews only a small percentage of the accounts filed with them due to lack of resources and the “Due Documents Received” notification on a charity’s entry on Charity Register means only that something has been received, with no means of distinguishing a charity that is filing merely cursory minutes from an AGM and one that files an exemplary set of financial statements comprising a TAR, accounts and an IER meeting the regulations. As Morgan acknowledges, “the enforcement of standards is thus, mainly down to the work of auditors and independent examiners” rather than standard enforcement by the regulator (2011b, p218).

2.4 Qualified Scrutiny Reports

Accounts are said to be “qualified” if issues come to light in the course of the examination that mean the examiner cannot give the required negative assurances (Table 1) or that a matter needs highlighting for the benefit of the reader’s understanding of the accounts with any such qualifications incorporated in the IER or audit report. More accurately it is therefore the IER or audit report that is qualified rather than the accounts. Sometimes an IER or audit report draws attention to a particular item or statement in the accounts without actually qualifying the report: this is described as an “emphasis of matter” report. The willingness of auditors to deliver qualified reports when appropriate and to exercise whistleblowing duties is seen as an important indication of audit quality (Holm and Zaman 2012, Maroun and Solomon 2014, Maroun 2015) but the issue appears to have received little prior investigation in relation to charities.

Where issues are identified by the independent examiner which may be considered material to the reader, the IER should give a clear explanation as well as an estimate of the financial effect on the accounts (Charity Commission 2017b). The Commission notes that whether something is material is a judgement by the examiner, which may depend on the value of a transaction, or the proportion of missing records etc.

Repeated studies have found non-SORP compliant accounts yet few receive qualifications (Palmer and Vinten 1998), suggesting “lack of commitment to the SORP by the sector and the [auditing] profession” (Cordery and Baskerville 2007, p13). Morgan and Fletcher’s study, showed that only 0.5% of accounts filed with the Charity Commission (income between £100k-£500k) were qualified by the auditor/ independent examiner, but a further 4.3% should have been qualified on the basis they were neither receipts and payments nor accrual format alone, suggesting sub-standard examinations (2011, p91-92). The Charity Commission’s accounts review (Charity Commission 2016b), found 1.8% of charities sampled had qualified accounts and 2.7% had emphasis of matter paragraphs (there may be some overlap in these figures), indicating the incidence of qualified scrutiny reports is still very low.⁸

Even where the term “qualified report” is understood as a report with qualifications/issues of concern highlighted, there is lack of common understanding of when qualification is appropriate, illustrating the subjective and interpretive nature of accountancy. In the commercial sector, following the banking crisis of 2007/08, auditors were challenged for not

⁸ The Commission made no reference to how many of the sample reported they had qualified reports.

providing qualified reports thus warning stakeholders of the financial risks the banks were taking (Gray, Manson and Crawford 2015). Similarly, in the charity sector, in relation to the enquiry into collapsed charity, Kids Company, differing views of what an unqualified audit report ought to evidence were presented in Parliament (House of Commons Public Administration and Constitutional Affairs Committee 2015) ranging from “a clean bill of health” (committee member) or merely no “significant deficiencies in internal control” (auditor). This illustrates that an unqualified audit/IER provides little reassurance against charity mismanagement, so the Charity Commission’s concentration on qualified reports may mean they miss the charities with the most concerning accounts.

2.5 Stakeholder Response to Qualified Reports

The Charity Commission’s major interest in qualified scrutiny reports is recent. In 2013 William Shawcross, then Chair of the Charity Commission, outlined plans to identify abuse and mismanagement in charities, taking a risk-based approach, stating that defaulting accounts often indicate wider management and governance issues including “deliberate abuses”. Shawcross promised to monitor charities’ accounts to identify risk factors and “to mark qualified accounts against a charity’s entry on the online register. The public should be able to see at a glance that a charity’s accounts have been questioned by an independent assessor” (Shawcross 2013). This general approach “informed by risk assessment and analysis” marks a shift in regulatory approach (McDonnell and Rutherford, in press).

As noted, the inclusion of qualified reports as a “matter of material significance” from April 2017, now compels independent examiners to report a charity to the regulator, every time they issue a qualified or modified report, so qualified reports become a whistleblowing trigger. The auditor/independent examiner is “asked not to distinguish between technical qualifications or other matters as the charity regulator will consider the nature and impact of their report” (Charity Commission, OSCR & CCNI 2017, p19). The regulators give a clear suggestion that regulatory investigation is likely and “could impact on the charitable status of the organisation” (2017, p7).

It is too early to know how responsive the Commission will be to independent examiners/auditors reporting qualified accounts as a matter of material significance although in the case of auditors they recently expressed concerns about under-reporting (Charity Commission 2018). However, since the fieldwork reported in this paper, the Commission has reviewed the accounts of larger charities with income of over £1m (therefore requiring an audit) with going

concern qualifications⁹ (Charity Commission 2016c). Rather than charity mismanagement, the regulator acknowledged that instead they found “the on-going challenging financial environment was the underlying factor behind many of the charities’ stated difficulties” (2016c, p1), particularly for charities reliant on public sector funding and they found “several examples of financial recovery and orderly closure” (2016c, p9). In a further review of 10 of these charities assessed as being at high risk of financial distress, the Commission acknowledged that in the vast majority of these charities, trustees were “alert to changes in their charity’s financial stability through good financial procedures and reporting mechanisms” and demonstrated accountability by detailing in their TAR and accounts how they were attempting to tackle the issues (Charity Commission 2016d).

In terms of regulatory action, the Commission’s approach was in the main, to remind charities of their duties and responsibilities and provide guidance (2016c), and they found only two cases of “poor governance and lack of financial oversight” (2016d, p3), leading to one official regulatory warning being issued (Charity Commission 2017c). This indicates that the regulator is undertaking “proactive analysis” of charity accounts where they perceive risk (Charity Commission 2017c, p1), albeit on a small scale. The “emphasis of matter” paragraphs in relation to going concern were not synonymous with risk of financial mismanagement, and on the whole, official regulatory action as threatened by Shawcross was not required. Instead, a wider and softer, educative regulatory function was pursued, which alongside regulatory compliance monitoring, increases legitimacy and accountability of the sector with stakeholders (Cordery and Baskerville 2007).

In terms of the funders’ perspective, there is little literature assessing whether a qualified IER/audit report has any impact on funding decisions. Firth (1978) hypothesised in relation to commercial investment decisions that where companies had qualified audit reports, share prices would fall. His research concluded that some types of information within the audit report informed investment decisions but that investors reacted differently depending on the type of audit qualification (e.g. going concern) but that any impact of the qualified audit was short-lived with any negative price reactions tending to be immediately after the audit report (new information) was released.

There is little literature on how charities themselves respond to receiving qualified reports. As detailed in the report above (Charity Commission 2016d), the regulator found that trustees were attentive to the going concern issues highlighted by the “emphasis of matter”

⁹ Charities with “emphasis of matter” paragraphs were sought but interestingly, the Charity Commission did not use the self-reported data as a mechanism for identifying charities with qualified reports.

paragraphs before the audit reports were issued (trustee actions noted in the TAR and accounts), but this may not be the case where qualification was on a more technical matter. Broadly speaking, charities can either respond to receiving qualified reports by addressing the issue, thus hopefully avoiding future qualification or by ignoring the qualification and the issue it refers to.

In the commercial sector, audit theory recognises a phenomenon of “opinion-shopping” as a firm’s possible behavioural reaction following an adverse audit report, usually by changing auditor (which, due to the auditor’s fee-dependence, may make them less likely to issue a qualified report (Craswell, Stokes and Laughton 2002). There is very little literature on this in the charity sector, although in the US Tate (2007) finds that organisations where an auditor raises concerns are more likely to switch firms, but this is contradicted by Beattie et al. (2006) in a study of large charities and non-profit audit change in the UK. However, Morgan (2011a) found that the average number of examinations undertaken by individual examiners was only 4 or 5 a year, so independent examiners are unlikely to be fearful of qualifying accounts due to any risk to their livelihoods – though some, especially those who are not accounting professionals, may possibly lack the confidence to give unfavourable reports.

2.6 Summary of findings from the literature

The literature suggests that whilst the aim of mandatory frameworks for charity financial reporting is to hold charities accountable to their stakeholders, little attention is given to the audit/IE arrangements, even though funders value the fact that the accounts have been independently scrutinised. Qualified reports could indicate a chaotic approach to financial management, but may just indicate an isolated mistake such as wrong use of a single restricted grant due to a misunderstanding. With little research on qualified reports in the field of charity accounting yet increased prominence given to this issue by the regulator, research is needed both to establish the accuracy of charities’ self-reporting of qualified accounts and to explore the practical implications.

3. Stage I: Assessing the true incidence of qualified reports

3.1 Research Scope

The first phase of research considered the year-end accounts of registered charities within the English and Welsh jurisdiction, with financial years ending in the 12 months prior to 31st

December 2014 (the reporting period reported on when charities completed their Charity Commission Annual Return 2014 (AR2014) where their income was reported as between £100,000 and £250,000.

Only 38% of E&W charities are above the minimum £25k threshold for IE and for submitting accounts to the Charity Commission and therefore make a declaration to the Charity Commission about whether their accounts are qualified or not (when submitting online). Of these only 4% have income in excess of £1m (Charity Commission 2017a), so requiring audits rather than IEs.¹⁰

The income bracket chosen for study, representing 9% of all (E&W) registered charities and 26% of charities subject to the IE regime was chosen because the charities concerned were

- likely, by virtue of being well above the £25k threshold, to have had several sets of accounts independently examined (in previous years) and therefore should be familiar with the IE regime and have an understanding of the independent examiner's role in declaring accounts qualified or unqualified;
- more likely than very small charities (those with income under £100k) to seek grant funding (this was relevant because the research was also interested in the perceptions of grant-makers, of charities with qualified accounts);
- less likely than larger charities to have complex financial statements e.g. group accounts.

3.2 Data Source from the Register of Charities

A request was made to the Charity Commission for data from the Register of Charities in respect of all charities with a gross income of between £100,000 - £250,000. The Commission supplied information as presented in table 2.¹¹

Number of charities on the Charity Commission register with gross income between £100,000 and £250,000	14,792
Number that submitted an AR2014 and accounts	13,945
Number that submitted accounts but did not complete the AR2014	30
% of accounts submitted online	88%
Number of charities that reported they had accounts with qualified audit/IE report	1,095

¹⁰ Nevertheless, some Charities with income less than £1 million may have had an audit as a requirement of their governing document or level or assets or may have opted voluntarily for the higher level of scrutiny

¹¹ Some limitations of the data sent by the Commission for this study and how this was handled is discussed by Kemp (2016).

when submitting their accounts online.	
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Table 2: Data Extract received from the Charity Commission Register

From these figures, the number of charities in this band submitting accounts online (and therefore who answered the question relating to account qualification) was 12,298.¹² 1,095 of these charities (8.9%) stated they had qualified accounts. This is a much higher proportion than previous studies; 0.5% (Morgan and Fletcher 2011) and 1.8% with a further 2.7% having emphasis of matter paragraphs) (Charity Commission 2016b). Further probing of these figures was clearly justified.

3.3 Selecting the Sample for Investigation

The Charity Commission data list flagged the 1,095 charities that self-reported they had qualified accounts, when submitting their accounts online. These charities formed the research population. Two sub-samples were generated; a purposive non-random sampling process to select charities located in the Yorkshire and Humber region (which would potentially be more accessible at the interview stage) and a systematic random sample, with every 10th charity on the original list being selected for the sample. These two selections were combined, giving a sample of 199 unique charities, 18% of the research population.

3.4 Desktop Assessment and Findings

The accounts (accessed from the Commission's website) were studied for all 199 charities in the sample. The form of external scrutiny and whether the external scrutiny report was qualified or not, was recorded. No attempt was made to assess the accounts to judge whether or not the auditor/ independent examiner's opinion was justified (qualified or unqualified), as this was outside the scope of the study.

The desktop exercise categorised each charity, using similar categories to those used by Morgan and Fletcher (2011), so each was recorded as having one of the following:

- An audit – where the accounts included an audit report
- An independent examination – where the accounts included an IER with wording compliant with the 2008 Regulations.
- No accounts – where no accounts were attached to the charity's entry on the online Register of Charities for the financial year appropriate to their AR2014.

¹² 12,298 = 88% of 13,975 (13,945 +30).

- No external scrutiny report – where some form of financial information was attached but without any form of external scrutiny.
- Indeterminate – this choice was selected where there was some form of scrutiny but the report did not sufficiently resemble an audit report or IER, e.g. an accountant may have signed an income and expenditure sheet to say they have checked the statement, but there is no reference to the Charity Commission directions or wording appropriate to the 2008 Regulations.

For charities with viewable accounts and recognizable audit or IE reports, it was established whether either the report was

- Qualified – statements made within the scrutiny report indicating a qualified audit opinion, or, in the case of IER, that the examiner could not make an unqualified negative assurance or raised a matter for the reader’s attention.
- Unqualified – a standard report from the auditor or independent examiner.

3.5 Analysis of the Sample

From the accounts of the 199-charity sample, the type of scrutiny report in the accounts was noted and the results presented in Table 3.

	Number	% of sample
Audit reports	5	2.5
Independent examination reports	140	70.5
No accounts on CC website	29	14.5
Financial information submitted with no scrutiny report	15	7.5
Indeterminate scrutiny report	10	5
Total	199	100

Table 3: Type of scrutiny report of sample charities

From the accounts of each of the 199-charity sample, whether the scrutiny report was actually qualified was recorded as presented in Table 4.

	Number	%
Charities that stated they had qualified scrutiny reports	199	100
Charities that <i>actually</i> had qualified scrutiny reports	6	3
Charities that had unqualified scrutiny reports	139 ¹³	70
Charities where accounts were unavailable to view on the CC website (qualification unverifiable)	29	14.5
Charities where accounts had no or indeterminate scrutiny report (accounts not qualified by virtue of no appropriate scrutiny)	25	12.5

Table 4: Analysis of Scrutiny Reports of sample of 199 charities

As Table 4 shows, there were 29 charities with accounts missing from the Charity Commission website and a further 25 charities with no or indeterminate scrutiny reports. Excluding these, left 145 charities with definite qualified or unqualified reports. The proportion with qualified accounts is summarised in Table 5.

	Number in sample (after indeterminate cases excluded)	%
Charities that actually had qualified scrutiny reports	6	4
Charities that misinterpreted the question "Are your accounts qualified?"	139	96
Totals	145	100

Table 5: Number and % of charities that have qualified accounts and those who had misinterpreted the question

From analysis of the 199-charity sample, only 3% (6) of those that declared they had qualified accounts actually had qualified/modified scrutiny reports (4% of the sample, when indeterminate accounts are excluded). This represents 0.4% of the 12,298 charities that submitted accounts online with income between £100k- £250k. This is nearer to Morgan and Fletcher's findings (0.5% for charities with incomes <£500k).

It is also worth noting that 7.5% of the 199-charity sample had not submitted any form of scrutiny report and a further 5% had submitted some form of scrutiny that did not comply with the 2008 regulations (Table 3). Therefore, at least 12.5% charities are failing to meet charity

¹³ The 139 included two charities with scrutiny reports that unqualified, but which had emphasis of matter paragraphs – both in relation to going concern.

legal requirements at a fundamental level. This finding is reasonably consistent with the Morgan & Fletcher research (9.7% charities with no scrutiny reports and 4.5% with scrutiny not meeting regulatory requirements).

It follows that 96% of those charities that declared they had qualified accounts, mis-answered the Charity Commission question. This represents 8.5% of the 12,298 charities that submitted accounts online with income between £100- £250k. These charities are erroneously flagged as having qualified accounts, as the self-reported accounts status has been included on the charities' entry on the Register of Charities on the Charity Commission's website without any corroboration.

4. Stage II: Perceptions of the implications of qualified reports

The second stage explored perceptions about qualified reports amongst two groups: (a) people involved in charities that actually had qualified reports and (b) grant funders that might support such charities. It was decided to pursue for interview, charities with qualified reports, rather than the 96% of charities in the research population that mistakenly reported they had qualified reports. Interviewing mistaken reporters would have provided insight into possible different understandings of qualified reports, which is a valid avenue for further study. However, given the regulator's inference that qualified accounts were indicators of mismanagement, there was an intention to explore the perception of personnel within charities that actually had the experience of having qualified accounts as they were more likely to have considered the implications for the charity, especially in relation to seeking funding. This stage was limited in scope and does not offer any claim to be representative of the sector, but it assists in understanding the perception of qualified accounts.

Semi-structured interviews, followed by a process of thematic analysis were used to gather perceptions (Clarke and Braun 2013, Bryman 2003, Bryman 2016). For the first group of interviewees, purposive selection criteria were used to identify charities that had qualified accounts *and* which had grant income as part of their income mix. For the interviews with funders, a convenience sampling approach was adopted, based on the criteria of funders that were regionally local to the researcher and which offered grants to charities in the income band relevant to the research (£100k-£250k).

4.1 Interviews with charities with qualified accounts

Stage 1 identified six charities from the 199-sample, which actually had qualified scrutiny reports and these were considered for interview. A further two charities had unqualified reports but the audit/examiner provided emphasis of matter statements (one audit, one IE) in relation to a question of going concern. Whilst these were not qualified reports, they were also included for consideration for interview on the basis that a going concern note may also impact on funder decisions and they were therefore regarded as relevant to explore. These eight charities are henceforth referred to as QMSR charities (Qualified/ Modified Scrutiny Report) to distinguish them from the grant-making charities selected for interview as funders. From further scrutiny of their accounts, it was determined that only five out of the eight QMSR charities, were in receipt of grant income. One of these (modified, not qualified audit report) was rejected for interview on the basis of conflict of interest, as the charity was known to the first author. With these four charities targeted for interview, attempts were made to negotiate access through the charity contact as given on the Charity Commission website but only two charity contacts agreed to be interviewed.

A profile of these two QMSR charities, their IE report qualification/modification and a profile of the contact that agreed to be interviewed is presented in Table 7.

<i>QMSR Charity and staff</i>	<i>Income Profile</i>	<i>Qualification issue in IE report¹⁴</i>	<i>Profile of interviewee</i>
Charity A No paid staff	Annual Income c. £215k 6% Grant income	The examiner could not verify some specific figures in the income and expenditure account due to insufficient detail being kept relating to inter-company transactions from the trading subsidiary. The examiner also could not verify a specific figure in relation to the previous year's debtor figure.	Company secretary, former account manager in public sector.

¹⁴ Full details of the statements in the IE report are not given here, as this would allow identification of the charities.

Charity B Paid Staff	Annual Income c. £190k 95% Grants (from a combination of sources: lottery, local authority and grant-making charities)	The accounts were not qualified but the IE report had an emphasis of matter note drawing the reader's attention to a "Going Concern" note. This indicated the charity's unrestricted reserves were in deficit.	Manager, no accounting experience.
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Table 7: Profile of QMSR Charity Interviewees

4.2 Recruiting Funders for Interview

To recruit interviewees, three grant-making charities and one large grant-making institution all known to offer support to charities in the specified income band were contacted directly. The researcher also attended a forum event of representatives from 20 grant-making charities. Eight people from seven grant-making charities agreed to participate in interviews: these are referred to as 'funders' to distinguish them from the QMSR charities.

Three funder interviewees were paid staff, whose role was to assess grant applications and make recommendations to trustees, and five were trustees involved in the grant assessment and decision making. Table 8 gives a profile of the funder interviewees.

<i>Funder</i>	<i>Role of Interviewee in Grant-making charity</i>	<i>Financial Experience (other than in the grant-making charity)</i>	<i>Typical size of grants awarded</i>
1	Manager		£500-£5,000
2	Chair of Trustees	Career in banking	Typically £5,000-£10,000, occasional one-off grants up to £100,000, some multi-year.
3 & 4	Founder Trustees	Career in investment management (3)	£100 - £5,000
5	Founder Trustee		£1,000 - £5,000 for up to 3 years
6	Senior Officer		£5,000- £15,000 for up to 3 years
7	Trustee		£100 - £2,000
8	Trust Secretary		£6,000 - £40,000 for up to 3 years

Table 8: Profile of Funders

The funder participant responses cannot be regarded as representative of personnel in grant-making charities, as they volunteered to participate, potentially because they had a higher degree of interest in charity accounts than grant funders or donors generally. However, four of the interviewees overtly acknowledged they had little knowledge of charity accounting.

4.3 Interview process

During the course of the interviews, where the interviewee (funder or QMSR) interpreted qualified accounts in a sense other than the legal meaning, to develop a shared understanding, the researcher talked through a definition during the course of the interviews, using a prompt sheet. The researcher was careful to present this as the meaning intended by the Charity Commission, rather than conveying a “correct” definition.

The interview notes were analysed and thematically coded (Clarke and Braun 2013). The interview schedules imposed some thematic discussion, providing “top-down” as well as “bottom-up” theme development.

5. Discussion

5.1 Misunderstanding of a key concept

The quantitative findings show that 96% of charities stating they had qualified accounts mis-answered the question. The most likely reason is that the charity staff-member or trustee filing the accounts misunderstood the question and the key accounting concept it raised. One might anticipate that the larger the charity, the more likely they will have specialist finance personnel and/or experienced treasurers with finance backgrounds, who may be more familiar with the concept of “qualified accounts” in the accounting sense and therefore answer the question correctly in this context.

The interviews illustrated a range of different interpretations of the term “qualified accounts”. The QMSR B interviewee understood the term “qualified” to mean that the accounts had been “*found to be in order*”, so qualification was understood in the sense of having “*passed*”,

in the sense one might gain a qualification if one passes an exam. This interviewee also used the term “qualified” in the sense that the charity “qualified” for an independent examination i.e. that they had sufficient income to meet the IE threshold.

Half the funders were also unfamiliar with the term “qualified accounts” or, similar to the QMSR interviewee B, interpreted it as relating to the income threshold for scrutiny or the qualification of the examiner based on common sense assumptions.

The Charity Commission has since made modifications to the question it asks in relation to qualified accounts when charities submit their accounts online as part of their annual return process. At the time of writing there is a dialogue box that one can open for a definition of “qualified accounts” which gives the following definition:

“If a charity's accounts are qualified by its auditors it means the picture of the company's activities presented is not true, complete and fair. Sometimes referred to as a qualified opinion.”

This may be clearer than when completing the 2014 Annual Return, so a future study may reveal a smaller proportion of charities that mis-declare having qualified accounts. However, use of the term “auditor” in this explanation may further confuse respondents because independent examinations, rather than audits, are, as previously noted, the appropriate form of scrutiny for the majority of charities submitting accounts to the Charity Commission. Also, since only a minority of charities are structured as companies, the use of the term “company” in this explanation may cause further confusion. In any case, this explanation only appears if the user clicks for additional information.

5.2 Attitude to qualified reports

Interviewees attached different value significances to a qualified scrutiny report. The QMSR A interviewee described getting the qualified IER as “a major sin”. Despite feeling that having qualified accounts was shaming, the QMSR A interviewee perceived the qualification, “*more as a technical issue than a substantive one*”, and did not believe that it indicated weak management. He reported that trustees were concerned about the issue (that had only come to light during the IE) and the fact the accounts were qualified. The account qualification had precipitated change within the organisation, which the interviewee perceived as radical:

“We had to grapple with the awful prospect that we were going to have to get some professional help...particularly in light of the accounts being qualified.”

This interviewee demonstrated accountability to the charity's members (as both members and the main donor base) in explaining the qualification, the proposed course of action and the resource implications. Indeed, triangulated with information available in the accounts and TAR and on the charity website (which includes copies of the year-end accounts, the charity's annual return and governance and operational policies and procedures) the organisation clearly demonstrated a transparency to stakeholders, supporting the ethical model of stakeholder theory (Dhanani and Connolly 2012).

QMSR B had experienced a significant drop in funding (notably from the local authority) therefore the going concern note was not a shock to trustees, as the charity's financial crisis was apparent before the end-of-year accounts. The charity had already restructured the organisation's finances, management and service delivery. However the manager reported that the IER and the independent examiner's management letter to the trustees was still useful in that:

"It was fair and pointed out things we should be doing so in ways it gave me a bit of a vehicle and a flag to wave at trustees."

Both QMSR charities believed that the qualified IER itself provided impetus for making changes and provided an additional motivator to address the issues that had been identified as part of the IE process.

Among the funders (once the term in the accounting context was explained) there was a mixed initial attitude to qualified accounts. Whilst half the funders used phrases similar to "alarm bells would ring", the other funders responded more neutrally that it would depend on the nature of the qualification.

"These things are not necessarily bad things they are just things the auditor has raised a concern. It might not reflect all that badly on the organisation." (Funder 6)

Only one funder had consciously come across a grant applicant with qualified accounts. This is perhaps unsurprising given that, as this research confirms, qualified scrutiny reports are a rare phenomenon. The funder interviews were therefore largely based on hypothetical discussion rather than the interviewee's direct experience.

Almost all funders, regardless of whether or not they initially perceived qualified accounts to be a concern, were willing to probe deeper to understand the nature of the qualification and give the charities a chance to explain.

5.3 Impact on Funder Decision Making

Both QMSR charities were inclined not to draw attention to the account qualification to potential new funders, although both acknowledged that funders might wish to question them about information available in the accounts:

“If the reader has got any problems they can always come to us and discuss it with us; none have. It’s up to them to determine and interpret what the examiner said.”

(QMSR A)

However, neither QMSR interviewee thought that the information in their IER had had a negative impact on grant funding and both had been successful in getting some grants since the qualification and no funder had sought any clarification about the accounts.

The funder that had assessed an application with a qualified IER, reported that trustees had not disregarded the application because the charity had qualified accounts but on inspection, a “*significant financial problem*” emerged. Whilst the accounts were largely felt to be sound, and the qualification was over a “*process issue*”, qualification gave a concrete reason to decline the application, when other negative factors were also at play:

“We had other doubts about it and that financial uncertainty as demonstrated by the qualification was one reason to say no, so it did have some influence definitely but it wasn’t the only factor.” (Funder 8)

Only one funder took a hard line and felt that “*one of the three trustees would pick it [qualified accounts] up and the committee would reject,*” feeling that further clarification with the charity was not justified given time constraints and that they were always oversubscribed with strong applications.

Another funder felt that whilst a qualified IER would not trigger automatic rejection, it was a potential filter:

“If we had a huge number of applications that quarter it might find itself in the reject pile, especially if it hadn’t been a particularly strong application”

However, funder interviewees largely perceived themselves as open minded about charities with qualified accounts. Seven funders were sure that they would not dismiss an application *per se* because it had a qualified IE report but reported they would seek further clarification from a charity if needed. However, a poor explanation may be a reason not to award a grant.

The funders interviewed did not dismiss formal accounts as documents that were impenetrable or difficult (Connolly and Hyndman 2013b) and were confident in extracting a number of pieces of information from the formal accounts, such as reserves levels, income & expenditure fluctuations and other sources of income, which they used to construct a view of a charity's financial health that informed their decision-making. However, there was less interest in regulatory or legal compliance of the charity accounts. Typically the funder interviewees aimed to take a *"balanced view"*, looking at *"the whole picture"*. Only three funders said they read the IER but all three said that they gave it limited attention. Therefore most interviewees were unlikely to identify directly from the accounts, whether a charity actually a qualified report.

5.4 Implications for the Regulator

The QMSR A interviewee was aware that the information about their qualified accounts would be highlighted by the Commission, and feared there would be consequences from the regulator, when confirming, on filing the accounts, that they were qualified.

"My finger hesitated over that button and I cursed, but pressed it."

The quantitative finding that 96% of charities flagged by the regulator as having qualified accounts are flagged erroneously underlines the lack of corroborative checks done on information filed with them, it is therefore unlikely that the Charity Commission are using the mechanism of self-declaration of qualified accounts as a trigger for regulatory action.

Findings from this study, that 12.5% of charities in the sample had no, or inadequate scrutiny report, reiterates previous research (Morgan and Fletcher 2011), yet these charities are not being singled out as non-compliant but are positively endorsed with the "due documents received" statement on the Commission's website and outnumber the 8.9% flagged up for self-declaration of account qualification. This non-compliance illustrates a lack of awareness or adherence to charity accounting requirements, and failure to provide the information that, according to the Charity SORPs is key to demonstrate "trustees' stewardship and

management of charitable funds” and is arguably a more significant indication of poor management and accountability than a charity that has submitted themselves to external scrutiny but where an examiner has qualified their report but in doing so has identified an issue that can then be addressed by trustees.

A theme apparent among funders was trust in the data from the Charity Commission website and an assumption that information has been verified and met the required standards. Seven funders used the Charity Commission register, at least sometimes, for information on applicants.

“We pay huge amount of attention to the Charity Commission information and I know that they are not perfect, but it’s the only place to go isn’t it? ... It’s part of our due diligence. It’s the first place I go towe look at the profile and the snapshot of the accounts.” (Funder 5)

Funders looked to the Charity Commission for an opinion about the charity e.g. whether the charity is legally compliant, rather than funders looking for this reassurance in the IER, which was not always read by the funders interviewed.

6. Conclusion

There is little research that explores “qualified accounts” in charity accounting, especially under the independent examination framework, which is the framework appropriate for 96% of E&W registered charities requiring external scrutiny. Based on a representative sample of charities in the £100k to £250k income range, this study has shown that 8.5% of charities reported to the regulator that they had qualified reports. This information is displayed on their entries on the Charity Commission’s Register of Charities, available for use by funders and other stakeholders. Yet the study found that 96% of these charities had mis-answered the question, illustrating that there is significant misunderstanding of this key accounting term.

This study has documented the increasing interest shown by the regulator in qualified reports as an indicator of financial mismanagement, which has led to the statutory duty being placed on independent examiners to notify the regulator if they issue a qualified report. Whilst stressing the significance of qualified report, the regulator is also publicly displaying inaccurate information about which charities have them, highlighting the lack of verification by the regulator on information submitted to them. This risks the trust of wider stakeholders, as grant-making charities look to the regulator as a source of reliable information about applicant charities.

The study shows that an assertion that accounts are qualified (when in 96% of cases this is not so) indicates trust in the Charity Commission website by the funders may be misplaced. (Funders also expressed concerns at the Commission's Register showing "due documents received" when a charity might have filed incomplete accounts, though this was outside the scope of the present study.) Funders would clearly be best advised to use the Register as a source for obtaining the accounts (if they do not already have them) and then to make their own assessment of the charity from the year-end accounts including reading the scrutiny report.

Nevertheless, this study found that neither charities with qualified IERs, nor the majority of funders interviewed, necessarily consider a qualified report as a definite indication of mismanagement, but rather a signal to ask questions. Moreover, having qualified accounts (even when they were actually qualified) did not appear to be a significant barrier to charities obtaining grant funding.

In practice this is supported by recent studies from the Charity Commission. Whilst demonstrating that the Commission is taking an interest in *audit* opinions at least, these studies show that modified reports are not generally used as automatic indicators of mismanagement. The role of the regulator in relation to charities with modified reports has been as educator and promoter of good practice, rather than initiator of regulatory intervention.

Nevertheless, many charities in the £100k to £250k income band are applying for external funding in various forms, and it is clear that funders place importance on charity accounts when making decisions. Whilst the study only undertook a small number of funder interviews, it is evident that grant-makers supporting such charities make use of and assume the validity of the Charity Commission's online Register of Charities and do not always have time to read the accounts in full. So, charities that wrongly answer the qualified accounts question may well be damaging their reputation, risking the possibility that funders may exclude them (or at least de-prioritise their applications).

However, the study shows that there is significant misunderstanding of the term "qualified accounts" both by charities filing their accounts with the Commission and, it would appear, also by funders who use the Commission's Register. Perhaps a complete new term is needed, especially for smaller entities subject to external scrutiny of their accounts, which avoids the technical auditing concept (subsequently extended to IE) of a qualified report.

In the meantime, it would appear that charity regulators in any jurisdiction seeking information from charities as to whether their accounts have received a qualified report from their auditor or independent examiner either need to extract this information from the accounts themselves or find a much less confusing way of wording the question to charities than that used by the Charity Commission at the time of this study.

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