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WHISTLE BLOWING - A NEW REGIME

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Although much has been written and said about the new accounting regulations for charities enshrined in the Charities (Accounts and Reports) Regulations 1995 and SORP 2 - "Accounting by Charities", there is one detail in the Regulations to which this article draws attention, for it deserves not to be overlooked amid all the other considerations engendered by the new accounts and reports requirements to which charities are now subject.

Tucked away in regulations 6(5) and 7(g) of the Regulations (which came into force on 1st March 1996) are a couple of provisions which require the auditors of larger charities (i.e., those with a turnover in excess of £250,000) to report on matters of which they become aware to the Charity Commission if the auditor has reasonable cause to believe that the information would be of material significance to the Commissioners in the exercise of their powers under sections 8 or 18 of the Charities Act 1993. In the case of smaller charities the corresponding provision requires the independent examiner to report to the charity trustees on any material expenditure or action which he believes not to be in accordance with the trusts of the charity, or if there is any information or explanation with which he has not been supplied upon request or if there is any inconsistency between the trustees' report and the statement of account.

This article reviews in some detail the implications of these legislative changes and points to some of the issues and practical implications for finance directors and others concerned with the annual audit of the charity's accounts.

Legislative Background

Readers will be familiar with the terms of Part VI of the Charities Act 1993 which sets out the new legislative framework for charities' obligations to keep accounting

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records, prepare annual statements of account and subject these to either an annual audit or examination depending on the charity's gross income or expenditure. The Regulations flesh out the detail, as envisaged by the Act, and are complemented by the Statement of Recommended Practice.

The underlying purpose of Part VI of the Act is (broadly) to subject charities which are not incorporated as a company to a regime which is similarly stringent to that to which charities which are incorporated as companies are subject by virtue of Part VII of the Companies Act 1985. Naturally, there are differences, but it is not the purpose of this article to examine these, save to draw attention to the fact that Part VI of the Act applies *only* to charities which are not incorporated as a company, leaving those which are (apart from the implications of SORP 2) to be regulated under Part VII of the Companies Act 1985. As there are no provisions corresponding to regulations 6(5) and 7(g) in the Companies Act, the result is that this new regime is tougher on the unincorporated charity than it is on the incorporated charity. Apparently the DTI intends to introduce legislation to remedy this imbalance.

The new regime can be seen as part of a wider policy decision to place on auditors a duty to report to third party regulators in the event of them becoming aware of anything "untoward". There is a parallel, for example, in the financial services industry where the Auditors (Financial Services Act 1986) Rules 1994 require an auditor of a business carrying on investment business to report to the relevant regulator any circumstances in which the auditor has reasonable cause to believe that the matter is or is likely to be of material significance for determining either whether a person is a fit and proper person to carry on investment business or whether disciplinary action should be taken or intervention powers exercised in order to protect investors from a significant risk of loss. Suitably adapted for the requirements of the Charities Act, that is just what these two regulations seek to do.

Regulation 6(5)

For the purposes of the following analysis it is worth quoting the regulation in full:

> "The auditor shall communicate to the Commissioners, in writing, any matter of which the auditor becomes aware in his capacity as such which relates to the activities or affairs of the charity or of any institution or body corporate connected with the charity and which the auditor has reasonable cause to believe is, or is likely to be, of material significance for the exercise, in relation to the charity, of the Commissioners' functions under section 8 (general

> power to institute enquiries) or 18 (power to act for the protection of charities) of the 1993 Act."

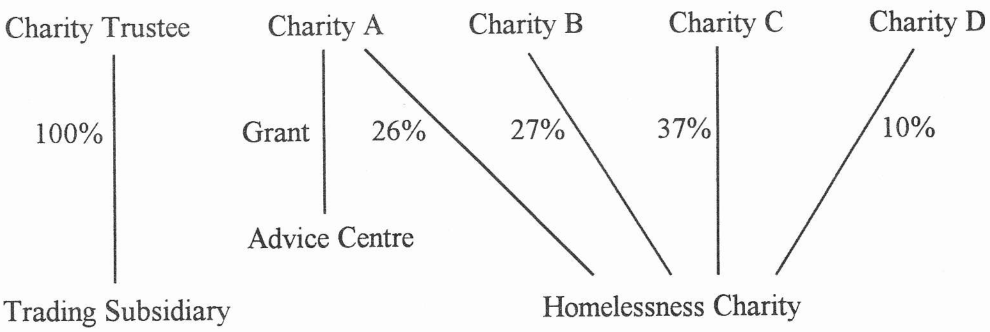
The regulation places the auditor under a statutory duty ("shall") to communicate any relevant matter to the Commissioners, and accordingly any failure by the auditor to do so could be a breach of statutory duty. Auditors will, therefore, when carrying out their annual review, be very mindful of the specific duty that they are now required to perform under this regulation, and will have regard to SAS 620, a draft of which is currently out for consultation. Anything to be reported must, in any event, be reported in writing; any such report will require careful drafting, which will undoubtedly be carried out at the cost of the charity.

A report only has to be made by the auditor, however, insofar as he becomes aware of the matter "in his capacity as such". Many auditing firms are now multi-disciplinary practices and may provide management consultancy or IT consultancy services to a charity, and if a relevant problem were to be unearthed in the course of performing such a function, then arguably the statutory duty would not arise. In practice, however, the prospect of a Chinese wall existing within such an organisation so that such matters were deliberately not brought to the attention of the auditing function of the firm must be, or should be, remote.

While the regulation expressly does not apply to a charity which is incorporated, it does also not apply to exempt charities falling within Schedule 2 to the Act, or to very small charities, having no permanent endowment or use or occupation of land and an income not exceeding £1,000 per annum if not registered. It will, therefore, catch charities established by trust deed or as unincorporated associations or societies and should also extend to industrial and provident societies and charitable friendly societies. It is, of course, also possible for the Commissioners to give dispensation under regulation 9 from the requirement to carry out an audit, or an examination by an independent examiner, where they are satisfied that the accounts will be audited under some other statutory regime.

However, assuming that the charity and its auditors are subject to this new regime, then the auditors have to report not only on the charity itself but on any "institution or body corporate connected with the charity". This can entail the auditors delving into a vast array of bodies connected to the charity they are auditing. The phrase just quoted is defined with apparent simplicity in regulation 2 and means an institution or body corporate which is, in the case of an institution, controlled by, and in the case of a body corporate is one in which a substantial interest is held by the charity, or any one or more of the charity trustees acting in his or her capacity as such. Regulation 2(2) defines in great detail when a person is "connected with a charity trustee" and this extends beyond the family connections to non-charitable trusts of which any charity trustee is a beneficiary or potential beneficiary, partnerships of his, or of any person connected with him or any body corporate which is not directly connected to the charitable institution but in which he or any other charity trustees or persons connected with him have a substantial interest. Paragraph 4 of Schedule 5 of the Act then helps with the definition of "a substantial interest" in a body corporate which (broadly) means the holding of one-fifth of the equity share capital of the company or being entitled to exercise one-fifth or more of the voting power at any general meeting of the body (which would be relevant for the purposes of any such company limited by guarantee). From the foregoing it will be obvious that searching questions can now be expected from the auditors as to whether there is any "institution or body corporate connected with the charity", for they will be in breach of their statutory duty if they fail (in appropriate circumstances) to report in writing on the activities of any such institution or body corporate. (An "institution" is defined by section 97 of the Act as including any "trust or undertaking".)

The following diagram, which is drawn from real life, illustrates a way in which the charity's auditors review can extend to at least four other "connected" organisations.



In this illustration, the activities of the trading company would need to be reviewed, even though the share capital was held by one of the charity trustees of Charity A (for example because Charity A did not have sufficient power in its Memorandum to hold shares in a trading subsidiary). Equally, charity A may set up a separate "institution" in the form of an advice centre which is not a separately established trust but which is nevertheless an "undertaking" and may, for example, be supported by the charity making grants to it. Finally, the homelessness charity in which Charity A has 26% of the voting rights would need to be investigated, and investigated not only by the auditors of Charity A, but also by the auditors of Charities B and C, assuming that they were not established as companies and otherwise fell under this new regime. In this scenario, three separate sets of auditors would (no doubt expensively) be involved with this statutory requirement - in addition to any auditors that the homelessness charity itself may have!

Note that the auditor only has to make a written communication to the Commissioners if he has "reasonable" cause to believe that the information is likely to be of significant interest to the Commissioners for the purposes mentioned. The reasonableness test is an objective one and could, therefore, ultimately be tested in the courts. The expression also implies that there is an opportunity for a certain amount of negotiation with the auditor as to whether or not it is reasonable for the auditor to believe that what he discovers is likely to be of interest to the Charity Commissioners.

What is the Regime Intended to Catch?

Only matters which are of "material" significance for the exercise by the Commissioners of their functions under sections 8 or 18 of the 1993 Act need to be reported. Again the question of "materiality" raises opportunities for negotiation between any charity and the auditors thinking of making a report pursuant to this Regulation. The draft of SAS 620 makes it clear that this concept of "materiality" is not the same as for accounting purposes. Examples cited in SAS 620 include significant inadequacy in management of the charity, or breach of statutory requirements or a probable mis-use of charity property.

Assuming the "materiality" threshold has been crossed, the auditors must be satisfied that the matter is one which would be sufficiently significant for the Commissioners to consider exercising their functions under section 8. This is the section which authorises the Commissioners to institute enquiries and to direct persons to furnish accounts or statements in writing with respect to any matter in question, to furnish copies of documents, and to attend meetings and give evidence and produce documents at such a meeting.

Lest it be thought that such investigations are rather a remote possibility, it is worth bearing in mind that in their 1995 Report the Commissioners reveal that they opened 609 enquiries, and found 398 instances where there was "significant cause for concern". This level of activity on the part of the central monitoring unit in Liverpool was undertaken at a time when the regulations under consideration had not come into force, and it can only be supposed that this level of activity will increase when auditors start fulfilling their new statutory duty. Equally, lest it be thought that the section 18 powers are of academic interest only, it is worth noting from the 1995 Annual Report of the Commissioners that they:

- issued 130 orders for information;

- froze 45 bank accounts;
- restricted 30 transactions by trustees;
- appointed 3 trustees to boards of management (and exercised their powers to remove 9 trustees); and
- appointed 3 receivers and managers.

Apparently they believe that by such actions some £25.7 million of charity assets have been protected. Again, it is reiterated that this material level of activity on their part in pursuance of their powers under section 18 was before the new "whistle blowing" regime came into force and the use that the Commissioners have made of these powers is a clear indicator to auditors of the sorts of matters that they will be looking out for when performing their statutory duty under this regime.

What are the Commission Interested in?

It is instructive to analyse those cases where the Commission instituted investigations under s.18 which did give "significant cause for concern", because they represent a pointer to the sorts of areas at which trustees and finance directors should be looking with a view to taking remedial action before the auditor makes his next visit and starts looking for information which he is now under a statutory duty to report.

204 of the cases involved inadequate management controls, financial controls or arose in associated trading organisations. Some 55 revealed fund-raising abuse and 124 represented deliberate malpractice. The balance included improper political activities and tax abuse. There is a clear message here that if the auditors are to uncover matters which they feel they should report to the Commissioners for the purposes of section 8 then it is likely to be in these areas and in arrangements with any associated trading organisations, and accordingly it would be wise, on the basis that prevention is better than cure, and forewarned is forearmed, for finance directors to direct their energies to reviewing these particular matters before the next audit.

Further evidence can be obtained from a brief review of some of the matters mentioned by the Commission in their Decisions in the recent past. A celebrated case was that of the Royal British Legion (Decisions Volume I, August 1993). Very briefly, the Royal British Legion had a wholly-owned housing association to which it lent considerable sums of money leaving RBL nursing a loss of some

£900,000 when the housing association subsequently went into insolvent liquidation. The conclusions highlighted by the Decision were that:

(a) there was an overlap of membership between RBL and its main committees and those of the housing association which gave rise to potential conflicts of interest for those who were involved in both organisations. The fact that one party was the lender, and the other the borrower, was not borne in mind;

(b) weak administrative structures were in place and there were far too many committees resulting in a fragmented approach to management control. Further, minutes of meetings were not kept properly and decisions tended to be taken through "personal networking" rather than through proper management structures. Moreover, there were no terms of reference or appropriate reporting procedures;

(c) the charity was left without any proper protection when the housing association ran into problems and the terms of loans extended by the charity to the housing association were not adhered to;

(d) the charity trustees had no relevant property investment expertise, nor did they take any professional advice.

The Welsh Heart and Handicapped Childrens Society was another classic case; here, the charity was set up to provide medical equipment and assistance but its administration costs consumed 85% of its income. The main activity of the charity appeared to be the running of the weekly lotteries and most of the charity staff were devoted to this endeavour. All the finances were in the hands of one employee and in spite of the fact that the charity had a turnover of more than £¼ million, no quarterly reports or budgets were prepared for the charity trustees.

When they investigated the case, the Commission found that only some 3% of turnover went directly towards the charitable objectives of the society, and with some encouragement from the Commission, the trustees eventually agreed to wind up the charity. That was a case which came to the Commission's attention as a result of adverse press reports and the local authority licensing department who alerted the Charity Commission; plainly, in future, such problems are likely to be brought to their attention by auditors.

The case of the Fellowship Charitable Foundation is a salutary reminder of the desirability of implementing any suggestions made by the Commission as a result of enquiries which they have raised. In this instance, the Monitoring Unit, on making a visit, discovered that its earlier recommendations had been ignored and that the charity's continuing administrative problems had put the charity's property and reputation at risk. This cavalier approach was sufficient to warrant the appointment of a receiver and manager by the Commission who instituted new management and financial systems, appointed new trustees and caused a business plan to be prepared for the charity. It is thought that in this way some £1.5 million of assets were protected.

A receiver was also appointed in the case of the Royal Masonic Hospital. Here, enquiries were instituted after concerns were expressed about the "competence" of the board, some members of which had allegedly been benefiting from their position. The charity had undoubtedly developed a financial crisis largely because its objects had failed. The receiver and manager decided that the only solution was the sale of the main asset of the charity and its dissolution, and this has been implemented. Here, the obvious items that the auditors would have been able to discover (and would now correspondingly be under an obligation to report) were the aspects of the board's "incompetence" and the fact of the financial crisis of the charity.

The draft of SAS 620 helpfully sets out a large number of specific instances of failure on the part of trustees which are likely to give risk to a duty to report.

How does the regime under Regulation 7(g) differ?

For smaller charities there is a lighter touch of regulation in that the independent examiner reports not to the Charity Commission but to the charity's trustees. In addition to the specific accounting matters which that report has to deal with, there is now an obligation to report on:

(i) whether there has been any material expenditure or action which appears not to be in accordance with the trusts of the charity; or

(ii) if there is any information or explanation to which he is entitled and which has not been afforded to him; or

(iii) if there is any disparity between information contained in the accounts and in the report by the charity trustees.

Apart from encouraging charity trustees to ensure that their report tallies with the accounts, and that they co-operate with the examiner, the main innovation is that the examiner will have to report on "material expenditure" or action which appears to be in breach of trust. It is not obvious that examiners who are versed in accounting matters will necessarily be sufficiently qualified to take a view on the legal extent of the trusts of the charity and whether any action or expenditure is not in accordance with those trusts. This must essentially be legal advice, but the resolution of the problem probably resides in the fact that he only has to report such information which "appears" to him to fall within the requirements.

Of course, a board of charity trustees who ignore any of the points made in such a report could be vulnerable to an allegation of breach of trust if they failed to investigate the matter and either rectify the situation (if remediable) or desist from future conduct of that kind.

Conclusions

As will be clear from the foregoing, this regime marks a tightening up by the Commission of its regulatory duties; its already energetic Monitoring Unit will, in this way, be able to harness the endeavours of the entire network of auditors carrying out their annual functions amongst the charity sector in the country, and once firms of accountants get used to compliance with their new obligations and become familiar with the practicalities of implementing SAS 620 when it has been issued by the Accounting Standards Board there must be a very real prospect of further enquiries and investigations being formally instituted by the Commission - unless, that is, precautions are taken in advance to ensure that, when audits are carried out, the auditors are given no cause for making a report to the Commission.

This article has attempted to analyse some of the issues which should be addressed in that respect and to point to the sources of more detailed information. This must be another instance where "prevention is better than cure", and the message must clearly be that finance directors would be well advised to devise their own checklists to ensure that it can be demonstrated that competent management is in place, and consequently to reduce the risk of "the whistle being blown".