EXPLANATORY MEMORANDUM TO THE FRIENDLY AND INDUSTRIAL AND PROVIDENT SOCIETIES ACT 1968 (AUDIT EXEMPTION) (AMENDMENT) ORDER 2006

2006 No. 265

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This statutory instrument will raise the threshold above which non-charitable Industrial and Provident Societies (IPSs) are required to appoint an auditor to audit their end of year accounts and balance sheets to £5.6m turnover and £2.8m balance sheet total, in line with the existing thresholds for non-charitable companies. It will also raise the asset level to £2.8m for charitable societies, whilst leaving the turnover amount at £250,000.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 Section 4(1) of the Friendly and Industrial and Provident Societies Act 1968 ("FIPSA") imposes on IPSs an obligation to appoint a qualified auditor to audit their end of year accounts and balance sheet. This requirement is limited by section 4A of that Act (which was inserted into that Act by S.I. 1996/1738) by disapplying the requirement in relation to non-charitable IPSs whose asset value is more than £1,400,000 and whose annual turnover is more than £350,000. In relation to charitable societies the asset figure is the same as for non-charitable societies, but the turnover figure is £250,000.

4.2 This instrument amends section 4A of the FIPSA so that section 4 of that Act is disapplied in relation to non-charitable IPSs whose asset value is more than £2.8m and whose annual turnover is more than £5.6m. For charitable societies the asset value threshold is also raised to £2.8m, but the annual turnover figure remains at £250,000.

4.3 The instrument is to be made under section 2 of the Industrial and Provident Societies Act 2002, which enables the Treasury to modify by means of an order, certain statutory provisions, including section 4A of the FIPSA, for the purpose of assimilating the law relating to companies and the law relating to IPSs. This instrument assimilates changes to the law relating to companies following the adoption of the Companies Act 1985 (Accounts of Small and Medium-sized Enterprises)(Amendment)(Regulations) 2004 (S.I. 2004/16). It is the first exercise of the power under section 2 of the 2002 Act.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury, Ivan Lewis, has made the following statement under section 19(1)(a) of the Human Rights Act 1998:

In my view, the provisions of the Friendly and Industrial and Provident Societies Act 1968 (Audit Exemption) (Amendment) Order 2006 are compatible with the Convention rights.

7. Policy Background

7.1 This instrument is being made to ensure that the audit threshold for non-charitable IPSs is set at a sensible level compared with a) non-charitable companies and b) charitable IPSs.

7.2 Under previous legislation the audit threshold for non-charitable IPSs was a turnover of not more than £350,000 and assets if not more than £1.4m, and for charitable societies the asset figure is the same, but the turnover figure is £250,000, as set out in section 4.1.

7.3 By comparison, non-charitable companies registered under the Companies Act 1985 with a turnover of not more than £5.6m and whose balance sheet total is not more than £2.8m do not need to have their accounts audited[1]. Community Interest Companies (CICs), a legal form that uses company law as its basis and which, like many IPSs, pursue social enterprise goals, are subject to the same thresholds as non-charitable companies.

7.4 The Charities Bill, which is currently before Parliament, will raise the audit threshold for charitable IPSs from £250k turnover and £1.4m balance sheet total to £500k turnover and £2.8m balance sheet total. If the Bill is passed in its current form, the audit threshold for charitable societies would therefore be raised above that for non-charitable societies.

7.5 This instrument therefore seeks to ensure a level playing field in this area between non-charitable IPS, non-charitable companies and CICs and to address any potential legal anomalies arising in respect of charitable IPSs. The opportunity is also being taken to raise the audit threshold for charitable IPSs to a comparable level with charitable companies.

7.6 The Government is committed to a level playing field between companies and IPSs, where appropriate. This instrument gives smaller non-charitable societies the opportunity to decide, like smaller non-charitable companies, whether they want to subject their end-year accounts and balance sheet to an

[1] The Companies Act 1985 (Accounts of Small and Medium-sized Enterprises)(Amendment) Regulations 2004 raised the audit threshold for non-charitable companies from £1m turnover and £1.4m balance sheet total to £5.6m turnover and £2.8m balance sheet total

independent audit (perhaps for reputational reasons) or whether the cost savings from not having an audit could be put to better use within the business. The Instrument also provides for an increase in the asset threshold for charitable IPSs as a transitional measure, until they are brought within the arrangements proposed in the Charities Bill. As outlined in the attached Regulatory Impact Assessment, up to 1200 societies would no longer be required to have their accounts audited. If it were assumed that an audit costs £2000 then raising the threshold could save the sector up to £2.4 million.

7.6 13 responses were received to the July 2004 consultation document, "Regulatory issues for Industrial and Provident Societies", which asked for views on the proposal to raise the audit threshold for industrial and provident societies. There was near-unanimous agreement with this proposal.

7.7 Although there is concern within the sector that there should be a level playing field, where appropriate, between societies and companies in areas such as audit thresholds, public interest in this proposal is low.

8. Impact

8.1 A Regulatory Impact Assessment for this proposal is attached to this Explanatory Memorandum.

8.2 There is no impact on the public sector as this instrument only applies to IPSs.

9. Contact

9.1 Nigel Fawcett at HM Treasury (Tel: 020 7270 4314 or email Nigel.Fawcett@hm-treasury.x.gsi.gov.uk) can answer any queries regarding the instrument.

Final regulatory impact assessment proposals to raise the audit threshold for industrial and provident societies

1. Proposal

1.1 The Friendly and Industrial and Provident Societies Act 1968 (Audit Exemption) (Amendment) Order 2006

2. Purpose and intended effect of measure

Objective

1.2 The aim of the proposal is to raise the threshold above which non-charitable Industrial and Provident Societies are required to appoint an auditor to audit their end of year accounts and balance sheets to £5.6m turnover and £2.8m balance sheet total (from £350,000 turnover and £1.4m balance sheet total). This is in line with the existing thresholds for non-charitable companies. The opportunity is also being taken to raise the asset threshold at which an audit is required for charitable industrial and provident societies from £1.4m to £2.8m. The turnover threshold will remain unchanged at £250,000. This is in line with charitable companies.

Devolution

1.3 Responsibility for Industrial and Provident Society law rests with the Chancellor of the Exchequer. It is an area that is reserved to Westminster under the Scottish and Welsh devolution legislation and therefore these changes will apply to Industrial and Provident Societies in Great Britain. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive Ministers. While the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

Background

1.4 The Friendly and Industrial and Provident Societies Act 1968 generally requires societies to appoint a qualified auditor to audit their end-year accounts and balance sheet. Non-charitable societies with a turnover of not more than £350,000, with assets of not more than £1.4m, can choose to disapply this obligation[2]. By comparison, non-charitable companies registered under the Companies Act 1985 with a turnover of not more than £5.6m and whose balance sheet total is not more than £2.8m do not need to have their accounts audited[3]. Community Interest Companies (CICs), a legal form which uses company law as its basis and which, like many Industrial and Provident Societies, pursue social enterprise goals, will be subject to the Companies Act audit thresholds for turnover and assets.

1.5 The situation for charitable companies and societies differs. The Charities Bill, currently before Parliament, proposes to change the conditions that

[2] See section 4A of the Friendly and Industrial and Provident Societies Act 1968. Note that this choice is not open to societies that are credit unions, registered housing associations, registered social landlords or insurers, societies that are or have subsidiaries and societies holding deposits. Also note that a society which chooses to disapply the obligation must nevertheless obtain a limited ‘accountant’s report’ from a person qualified as an auditor if its turnover in the relevant year exceeded £90,000.

[3] See section 249A(3) of the Companies Act 1985. However, this does not apply to certain categories of companies, including those carrying on insurance or banking or which are or have subsidiaries.

need to be met so that a charitable company can prepare an accountants report rather than needing its accounts audited. Currently charitable IPSs are exempt from the provisions of the Charities Act 1993. As a transitional measure, before the enactment of the Bill and the extension of the new audit thresholds to charitable IPSs in 2007, it is proposed to raise the audit threshold broadly in line with charitable companies. A slightly different formula is used for the audit threshold for charitable companies, as a result it is proposed only to raise the assets threshold figure.

1.6 The table below compares the relative audit thresholds for the different legal forms, under current legislation and following implementation of the Home Office proposals.

	Current audit threshold		Revised audit threshold (following implementation of Home Office proposals)	
	Turnover/gross income (£m)	Assets (£m)	Turnover/gross income (£m)	Assets (£m)
Company/CIC	5.6	2.8	5.6	2.8
Charitable company/society	0.25	1.4	0.25	2.8
Non-charitable society	0.35	1.4	5.6	2.8

Rationale for Government Intervention

1.7 There are two main impacts if there is no Government intervention. First, if the Home Office proposals for charitable societies and companies are implemented as they currently stand, this risks creating a potentially anomalous situation where the audit thresholds for charitable societies are higher than those for non-charitable societies. It would appear inappropriate for non-charitable societies to be subject, in this case, to greater regulatory requirements than charitable societies. Secondly, unless the audit threshold is raised, non-charitable societies will not be able to operate on a level playing field with non-charitable companies. For charitable societies the proposal will align them more closely with charitable companies.

3. Consultation

Within Government

1.8 HM Treasury has consulted the Home Office, the Department for Trade and Industry, the Department for Constitutional Affairs and the Financial Services Authority.

Public consultation

1.9 On 30 July 2004, HM Treasury published a consultation document. “Regulatory Issues for Industrial and Provident Societies” on (amongst other proposals) the option to raise the audit threshold for non-charitable Industrial and Provident Societies. The consultation document is available on the HM Treasury website and printed copies are available on request. The deadline for comments was 29 October 2004.

1.10 A total of 13 organisations and individuals responded to the consultation. Where consultees were asked for views about the audit threshold, there was near unanimous agreement that the audit threshold for non-charitable societies should be raised, with many commenting that it should be at the same level as that for non-charitable companies. Consultation respondents did not disagree with the costs and benefits of the proposals suggested in the partial Regulatory Impact Assessment contained in the consultation document and none sought to further identify or quantify any other costs or benefits. A summary of responses to this consultation is available at HM Treasury's website or by contacting Aleem Wallani (e-mail to: Aleem.Wallami@hm-treasury.x.gsi.gov.uk or 020 7270 4957).

4. Options

Option 1: No action

1.11 As discussed above in paragraph 1.7, the risk of not raising the audit threshold is a) that non-charitable societies would be placed in an anomalous position compared to charitable societies and b) that non-charitable societies would not be able to operate on a level playing field with non-charitable companies in terms of auditing requirements.

Option 2: The turnover and asset thresholds below which non-charitable societies are exempt from the requirement to appoint a qualified auditor to audit their accounts and balance sheet should be increased to £5.6m (turnover) and £2.8m (assets). For charitable societies the turnover threshold will remain unchanged £0.25m and the asset threshold raised to £2.8m.

1.12 The principal purpose of a statutory audit for a company or society is to provide a reasonable assurance that the company/society's financial statements are free from material misstatements and fraud and show a true and fair view of the company's state of affairs. For a company, this is first and foremost for the benefit of shareholders. For a society, the audit may provide valuable information for members on the financial well-being of the organisation. Suppliers of finance, goods and services to a society may also place a reliance on the audit.

1.13 The risks of removing the requirement for smaller societies to have a statutory audit of their accounts are that:

- There is an increased risk that accounts will include errors or not be prepared in accordance with legal requirements (possibly leading to a loss of confidence in the entire sector);
- Errors in the accounts of societies could lead to a degradation in the quality of information filed with the FSA on registered societies;

- Societies may lose the external, independent check on their financial position, which protects the interests of members and suppliers of finance or goods and services against incompetent or fraudulent managers;

- It could lead to increases in the risk of undetected fraud against societies. (The statutory audit is not designed to detect fraud but it may do so and also acts as a significant deterrent);

- It may facilitate the use of societies for illegal purposes such as money laundering; and

- It may lead to higher costs to societies of borrowing capital from lenders, which may restrict further growth in that society.

1.14 However, it should be noted that an increase to the statutory audit threshold for affected societies would not prevent societies from taking up the option of appointing a qualified auditor to audit their end-year accounts and balance sheet, if they felt this would be useful for the purpose of enhancing the reputation of their society.

5. Benefits

Option 1:

1.15 The benefits of retaining the current audit exemption threshold are that:

- It provides an independent check on the reliability and accuracy of society accounts, for management, members and others;

- It may detect fraud against societies;

- It may prevent societies from incurring a higher cost for credit; and

- It may prevent the degradation of information on registered societies available from the FSA.

Option 2:

1.16 This option gives smaller societies the opportunity to decide, in the same way as smaller charitable and non-charitable companies, whether they want to subject their end-year accounts and balance sheet to an independent audit or whether any resulting cost savings can be put to better use within the business.

1.17 There are cost savings to a society in choosing not to have their accounts and balance sheet audited by a qualified auditor. If the threshold was increased from its current level to £5.6 million, up to a further 1,200 societies would no longer be required to have their accounts audited. If all these societies took advantage of the new threshold there would be a cost saving of up to **£2.4 million** (1,200 x £2,000 (cost of audit)) to societies (although it is likely that the larger the company the less inclined it will be to take advantage of the new threshold).

Business sectors affected

1.18 An increase in the audit threshold for non-charitable societies would allow all non-charitable societies with a turnover at or below £5.6 million to take advantage of the exemption from audit. Similarly for charitable societies those with a balance sheet total of £2.8 million or less and turnover of £250,00 or less will be able to take advantage of the exemption.

Issues of equity and fairness

1.19 We do not consider that the proposal will bring any disproportionate benefits or have disproportionate effects on particular groups.

6. Costs

(i) Compliance costs

Option 1:

1.20 The requirement to appoint a qualified auditor to audit the end-year accounts and balance sheet places a cost burden on industrial and provident societies. The cost of an audit varies depending on the size and complexity of the business. As a guide, the Collis Report into the implications of raising the audit threshold for small non-charitable companies[4] found that £1,000 was a typical fee for auditing accounts. The report also found that process of having accounts audited (appointing a qualified auditor, etc) could cost companies up to an additional £1,000 in directors' time. So the total cost of audit for small companies has been estimated at, on average, around **£2,000.**

1.21 There are in the region of 1,200 societies in the £350,000 to £5.6 million turnover range. If the audit threshold is retained at its current level of £350,000 the cost to societies in complying with the statutory requirements would be up to **£2.4 million** (1,200 x £2,000 (cost of audit)).

Option 2:

1.22 Increasing the audit threshold for societies as proposed above will not impose compliance costs on societies.

(ii) Other costs

1.23 We do not consider that the option to increase the audit threshold for societies will impose significant costs on sectors outside the Industrial and Provident Society sector. There may be a small cost to the audit sector in terms of audit fees. But this is unlikely to be significant since this change is only likely to affect up to 1,200 societies. If all 1,200 societies were to take advantage of the new threshold, this could lead to an overall cost to the profession of £1.2 million (based on a cost of £1,000 per audit).

7. Consultation with small business

1.24 The Government consulted with the Small Business Service and it was agreed that this proposal to raise the audit threshold for non-charitable societies will not have an impact on small business. The proposal to raise the audit threshold to the level for small non-charitable companies will, in fact, level the 'playing field' in terms of audit requirements, between non-charitable societies and non-charitable small firms. Similarly with charitable societies the more limited increase in the threshold will help to level the 'playing field'. The views of small businesses and their representative organisations were sought to confirm this view

[4] http://www.dti.gov.uk/cld/collis_rep.pdf

during a formal consultation process but no responses from such bodies were received.

8. Competition assessment

1.25 As the proposal gives non-charitable societies with a turnover of less than £5.6 million the option not to have their accounts audited, this proposal has no competition implications. Increasing the asset threshold for charitable societies to £2.8m is also expected to have no competition implications. For example, as far as the Government is aware, no individual community benefit society has more than 10% market share nor does it appear that the proposal would affect the market structure. In exempting smaller non-charitable societies from the cost of an audit, this proposal may in fact enable societies to compete more effectively with other bodies.

9. Enforcement and sanctions

1.26 The proposal to increase the threshold below which non-charitable societies are not required to have their accounts audited removes a burden on societies. No further enforcement is required other than that which already exists for enforcing the standards for industrial and provident societies, which is the responsibility of the Financial Services Authority.

10. Implementation and Delivery Plan

1.27 The proposal will be implemented by those affected societies choosing not to appoint an auditor where their turnover and balance sheet figures fall below the threshold figure that applies to them. The information enabling them to make a choice will be published on the Treasury website.

10. Post-Implementation review

1.28 The Government will review the thresholds for non-charitable societies in the light of any future changes to the thresholds for charitable companies and societies and to those for non-charitable companies. The audit threshold for charitable societies will be reviewed in the light of the progress of the Charities Bill.

11. Summary and recommendations

1.29 The Government recommends option 2. The benefits of raising the audit threshold are that it will ensure non-charitable Industrial and Provident Societies are able to operate on a level playing field with non-charitable companies. It will also remove a potential anomaly whereby the audit threshold for charitable Industrial and Provident Societies was higher than that for non-charitable Industrial and Provident Societies. Whilst the formula for the audit threshold for charitable companies differs from that for charitable industrial and provident societies, the amendment will keep them broadly in line and is within the scope of the powers contained in the 2003 Act.

1.30 The Audit Threshold Order is essentially de-regulatory in nature and is unlikely to create an administrative burden for societies that make use of the increased threshold. The FSA will not be actively monitoring IPSs use of the provisions.

‘I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs’

Signed by the responsible Minister

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Ivan Lewis, the Economic Secretary to the Treasury

Date……………………………………..

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