

## Policy Briefing

# Technical briefing: Account reporting and audit requirements

September 2016

In this paper we recommend that HM Treasury use its powers to make secondary legislation under the Co-operative and Community Benefit Societies Act to the following effect:

- Remove the requirement for the very smallest societies to appoint 'lay auditors'
- Update the turnover threshold at which societies can 'disapply' the full audit requirement from £5.6m to at least the company level of £6.5m
- Make the requirement for an auditor's report contingent on a threshold of share capital instead of turnover or on a special resolution at a general meeting

## 1 Background

1.1 Account audit and reporting requirements and thresholds are increasingly burdensome for smaller co-operative and community benefit societies (referred to as 'societies'), especially in comparison with those for smaller companies, including community interest companies (CICs). We are specifically referring to:

- The requirement for societies with a turnover under £5k to appoint 'lay auditors' to scrutinise their accounts (no such requirement for the smallest companies)
- The requirement for societies with a turnover over £90k to pay for a professional auditors' report (no such requirement for the smallest companies)
- The requirement for societies with a turnover over £5.6m to pay for fully audited accounts (for companies the same threshold is £6.5m)

1.2 These thresholds have not been updated since 2006 and in that time have grown increasingly burdensome due to inflation, and moreover again because company thresholds have been regularly updated.

1.3 Furthermore, there has been no review of the utility of the requirements themselves. A legislative review to consolidate society law in 2014, which led to the Co-operative and Community Benefit Societies Act (CCBSA), was unable to consider such matters. In contrast what is required of companies is also under regular review.

## 2 Differences in form and function

- 2.1 As companies and CICs are different in form and function from societies wholesale equality in statutory requirements is not always appropriate. Instead government should seek to provide an **appropriate equivalence** between legal forms.
- 2.2 We believe there are three crucial differences in form and function relevant to this matter:
- The regulated purpose and activity of societies
  - One member one vote democracy in societies
  - The ability of societies to raise share capital through retail investments outside the financial promotions regime
- 2.3 By law societies must operate for co-operative or communal purposes and cannot prioritise return on investment. The FCA Mutuals Team has wide-ranging powers to ensure societies operate in accordance with the law. It is especially diligent in preventing societies from being misused as enterprises which prioritise return on investment. The primary means by which the FCA Mutuals Team scrutinises societies in this regard is the Annual Return. This reduces (but by no means eliminates) the likelihood that the directors of small societies will seek to mislead stakeholders about financial matters for private gain.
- 2.4 Societies must operate on a democratic one member one vote basis, which again is subject to regulation by the FCA Mutuals Team. This means power in societies cannot be bought by some members at the expense of others. The collective power of members tends to act a counter to privileged interests in the business.
- 2.5 Both 2.3 and 2.4 are differences which to a degree reduce risk for financial stakeholders in societies and could justify small societies having less onerous account audit and reporting requirements than companies do.
- 2.6 However, the ability of small societies to raise share capital through retail investments outside the financial promotions regime justifies them having more onerous account audit and reporting requirements than companies. Small companies cannot feasibly raise capital from retail investors and so are not held to such high standards in account transparency. In contrast societies that have raised capital from a broader public, through community shares for example, should be held to higher standards in account transparency in the interests of investor protection.

## 3 Policy assertions

- 3.1 In light of the points made in **parts 1** and **2** above we make four assertions which should guide legislative action in this area:

- It is anomalous that the requirement for the very smallest societies to conduct a lay audit is more burdensome than societies with a turnover between £5k and £90k, for whom there is no audit requirement at all; this simply creates red tape for start-ups, and may discourage people from using the legal forms
- There is no rationale for societies being required to have fully audited accounts at a threshold that is £0.9m lower than that set for companies; this is costly red tape that puts growing societies at a commercial disadvantage
- Small societies that have not raised share capital from retail investors should not be required to pay for a professional auditors report, but rather should be subject to the same requirements as small companies
- Societies that have raised capital from retail investors should continue to be required to pay for a professional auditors report in the interests of investor protection

3.2 Thus we recommend that HM Treasury use its powers to make secondary legislation under the CCBSA to the following effect:

- Remove the requirement for the very smallest societies to appoint lay auditors (see **part 4**)
- Increase the threshold at which societies can disapply the full audit requirement from £5.6m to at least the company level of £6.5m (see **part 5**)
- Make the requirement for an auditor's report contingent on a threshold of share capital instead of turnover or on a resolution at a general meeting (see **part 6**)

#### **4 Removing the £5k 'small society' requirement**

- 4.1 Section 83 (1) creates a general requirement for all societies to appoint professional auditors. This should remain unchanged.
- 4.2 Section 83 (2) and (4) of the CBBSA state that 'small societies' with an annual turnover under £5k do not have to pay for professionally audited accounts, but must appoint 'lay auditors' instead.
- 4.3 HM Treasury should use its power under Section 134 ('Power to amend this Act to assimilate to company law') to align audit requirements for small societies with those for companies, by deleting Section 83 (2) to (6). The effect of this deletion must be understood in conjunction with **part 5** below.

## 5 Updating the threshold to ‘disapply’ full audit requirements

- 5.1 Section 84 allows for a society with a turnover up to £5.6m and assets up to £2.8m to ‘disapply’ Section 83 and excuse itself from the requirement to appoint professional auditors.
- 5.2 HM Treasury should use its power under Section 134 to align audit requirements for small societies with those for companies by increasing the thresholds in Section 84 (1) to an appropriate level, such as the turnover level set for companies, which is £6.5m. However, HM Treasury could make a strategic decision to set higher thresholds on the basis that these may not be updated again for some time.

## 6 Targeting the auditor’s report requirement at societies with share capital

- 6.1 Section 85 requires societies with a turnover over £90k that have disapplied the audit requirement to pay for an auditors’ report instead.
- 6.2 In order that the requirements for small societies that are *not* raising money from retail investors outside the financial promotions regime align with those of small companies, HM Treasury should use its power under Section 134 to amend Section 85 (1) (b) as follows:
- Delete:
 

*“(b) the society’s turnover in the preceding year of account exceeded £90,000”*
  - Insert:
 

*“(b) the society’s share capital in the preceding year of account exceeded £x,000”*
- 6.3 This would allow small societies that have not raised significant share capital to grow without facing additional requirements that not applied to small companies. At the same time it would require those societies that have raised significant share capital to have a professional auditors’ report.
- 6.4 To provide added protection to members the law could give them the right to require an auditor’s report regardless of the value of share capital, by passing a resolution at a general meeting. To do this, after Section 85 (1) (b) we could insert:
- “, or*
- (c) by virtue of a resolution passed at a general meeting”*

## 7 Next steps

- 7.1 We believe HM Treasury should determine what is possible through secondary legislation under the CCBSA and then consult societies on this

basis. It should then bring forward secondary legislation that reflects the views of the sector as soon as is practicable.

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