Title: Raising the Charity Audit Threshold **IA No:** CO **Lead department or agency:** Cabinet Office **Other departments or agencies:**	**Impact Assessment (IA)** **Date:** 31/10/2014 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Secondary legislation **Contact for enquiries:**

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
£61.31m	£61.31m	-£5.61m	Yes	OUT

What is the problem under consideration? Why is government intervention necessary?

The Government is committed to making it easier to run a charity, social enterprise or voluntary organisation. Charity law requires charities to be accountable but it is important that that the regulatory requirements are proportionate. At present, charities that have either a gross annual income of more than £500,000; or assets worth more than £3.26 million and an income of more than £250,000, must have their annual accounts audited by an auditor whose name appears on the Register of Statutory Auditors. In his review of the Charities Act 2006, Lord Hodgson recommended that this requirement was overly burdensome and the threshold needed increasing.

What are the policy objectives and the intended effects?

Lord Hodgson recommended that charities should only have to have their accounts audited if their income is more than £1 million, with no asset threshold. The Government partially accepted this recommendation and we are now proposing to increase the income threshold to £1 million but to retain the asset threshold at £3.26 million so as not to create a discrepancy between charity and company law requirements. Charities with an income of over £25,000 that do not now require an audit must have their accounts independently examined, which is significantly cheaper but still provides independent assurance of the charity's finances. Thus, the intended effect of this policy is to exempt around 4,000 charities from the requirement of an audit in favour of a cheaper and less onerous independent examination by a qualified person.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 1: Do nothing: income threshold stays at £500,000 and the asset threshold stays at £3.26 million with an income of over £250,000. This is not advised because, as Lord Hodgson and the Government agree, such thresholds create an unnecessarily burdensome and costly requirement on charities.
Option 2: Raising the income threshold to £1 million and the asset threshold to £3.26 million with an income of £500,000 to £1 million. This is the Government's preferred option as it lifts a number of charities out of the audit requirement without creating a potentially confusing discrepancy between the charity and company asset thresholds. It continues to provide independent scrutiny of a charity's accounts by a qualified independent examiner, although not to the same degree as a full audit.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** By March 2018

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: **ROB WILSON** Date: **23.11.14**

Summary: Analysis & Evidence

Policy Option 1

Description: Do nothing

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2014	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** 0

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

In line with impact assessment guidance the do nothing option has zero costs or benefits as impacts are assessed as marginal changes against the do nothing baseline.

Other key non-monetised costs by 'main affected groups'

In line with impact assessment guidance the do nothing option has zero costs or benefits as impacts are assessed as marginal changes against the do nothing baseline.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

In line with impact assessment guidance the do nothing option has zero costs or benefits as impacts are assessed as marginal changes against the do nothing baseline.

Other key non-monetised benefits by 'main affected groups'

In line with impact assessment guidance the do nothing option has zero costs or benefits as impacts are assessed as marginal changes against the do nothing baseline.

Key assumptions/sensitivities/risks	**Discount rate (%)**	3.5

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs:	**Benefits:**	**Net:**	Yes/No	**NA**

Summary: Analysis & Evidence

Policy Option 2

Description: Raise the Threshold

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2014	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 44.28	**High:** 99.79	**Best Estimate: 61.31**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	2.7		0	**2.7**
High	9.5		0	**9.5**
Best Estimate	5.0		0	**5.0**

Description and scale of key monetised costs by 'main affected groups'

Every charity is conservatively estimated to incur a transitional administrative cost burden of £22 in trustee time for familiarisation with changes in mandatory audit thresholds. Charities in the income/asset bands affected by the deregulation will incur transitional search costs estimated at £155 per charity, associated with finding a qualified independent examiner.

Other key non-monetised costs by 'main affected groups'

Additional costs considered include a rise in undetected charity fraud associated with the move from audit to qualified independent examination, resulting in a decrease in public trust in charities and possible fall in donations. This risk is mitigated by qualified independent account examination in place of audit, and any impact is estimated to be low and so costs were not monetised. There is no evidence to suggest an increased fraud risk.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		6.4	**53.8**
High	0		12.1	**102.5**
Best Estimate	0		7.8	**66.3**

Description and scale of key monetised benefits by 'main affected groups'

The proposed increase in both the income only and the income and asset audit thresholds will reduce costs associated with audit to around 3,800 registered (and an unknown but smaller number of unregistered charities). These charities will be required to have their accounts examined by a qualified independent examiner. The independent examination that will take the place of the audit is less costly, leading to substantial annual cost savings for charities, estimated at £2,250 per charity.

Other key non-monetised benefits by 'main affected groups'

There are no further expected benefits associated with the policy.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

1. The estimated average costs of audit and independent examination (and the resulting estimate for annual savings) for charities with annual incomes of £0.5-£1m have been obtained using small data samples. Whilst it's thought they are broadly representative, the annual benefit across all charities is sensitive to changes in these estimates.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 0.5	**Benefits:** 6.1	**Net:** 5.6	Yes	OUT

Evidence Base (for summary sheets)

The policy problem and rationale for Government intervention

The Government is committed to making it easier to run a charity, social enterprise or voluntary organisation.

Accurate, clear and publicly available information about charities' finances and activities is essential to ensure public confidence in both individual charities and the charity sector as a whole. Charity law requires charities to be accountable but it is important that that the regulatory requirements are proportionate. It is also important that, where it is a legal requirement, the independent external scrutiny of charities' accounts is carried out by people who are suitably qualified to carry out an examination in a way that is proportionate to the size of the charity.

The requirements for the independent scrutiny of charity accounts become increasingly demanding the larger a charity is until there is a requirement for annual accounts to be audited by an auditor whose name appears on the Register of Statutory Auditors, if a charity has:

- an annual income from all sources (income) of more than £500,000; or
- assets worth more than £3.26 million and an income of more than £250,000.

In his report on the operation of the Charities Act 2006 (the 2006 Act), Trusted and Independent: Giving charity back to charities (Trusted and Independent), Lord Hodgson of Astley Abbotts recommended that charities should only have their accounts compulsorily audited if their income is more than £1 million, with no asset threshold.

In its response to Lord Hodgson, the Government partially accepted this recommendation agreeing, subject to consultation, to increase the income threshold but also retaining and increasing the asset threshold, because it continues to believe that charities that have significant assets should be subject to a full audit even when their income is relatively low.

Policy objectives and intended effects

We are proposing to increase the thresholds that require a charity to have its accounts audited to:

- an income of more than £1 million; or
- assets worth more than £3.26 million and an income of more than £500,000.

The Government initially agreed to increase the income threshold but to retain and increase the asset threshold to £5 million. However, we are aware that the £3.26 million asset threshold is shared by companies under company law and are wary of creating a discrepancy. This does not affect the increase of the income threshold at which the asset threshold is triggered, and both options are currently being consulted on.

If, in future, the company law asset threshold were to be increased, we would consider a similar increase in the charity law asset threshold, to remain in line with the company law requirements.

The measure removes the obligation to have annual accounts audited by an independent auditor from an estimated 4,000 registered charities, who will instead only be required to have their accounts independently examined by a qualified person at a reduced cost. If implemented, the preferred policy option will therefore save charities money, whilst ensuring a proportionate level of accounts scrutiny.

Policy options considered, including alternatives to regulation

Option 1 – Do nothing

For charities with significant income or assets, an annual audit of charity accounts provides an important form of external scrutiny that ensures good financial management. However, an audit is an expensive and lengthy process and not necessary for all charities.

In the status quo, a charity with an annual income of £500,000 must have a full audit which, for a charity in this income band, could cost as much as £16,800. That would represent an outlay of over 3% of total income, a disproportionate burden to place on such a charity.

Thus, doing nothing is not advised because, as Lord Hodgson and the Government agree, the current thresholds impose an unnecessarily burdensome and costly requirement on some charities.

Option 2 – Raise the threshold

In *Trusted and Independent*, Lord Hodgson recommended that charities should only have to have their accounts audited if their income is more than £1 million, with no asset threshold. He argued:

> *A full audit is an expensive and time-consuming exercise and, although it is right that large organisations should submit to this level of scrutiny in the interests of good regulation and management, the current threshold of £500,000 income per year seems a low level at which to impose this requirement. A level of £1 million draws a better balance. On similar lines, the existing 'asset test' that requires organisations with assets worth £3,260,000 to undergo an audit was criticised by some as unnecessary and hard to apply in practice. This is an additional element of complexity that should be removed.*[1]

In its response to Lord Hodgson, the Government partially accepted this recommendation agreeing, subject to consultation, to increase the income threshold but also retaining and increasing the asset threshold, because it continues to believe that charities that have significant assets should be subject to a full audit even when their income is relatively low.

However, the Government is aware that the asset threshold above which companies must usually have their annual accounts audited also currently stands at £3.26 million. Specifically, company law currently requires limited companies to have their annual accounts audited if they meet two out of the following three criteria:

- assets worth more than £3.26 million;
- gross income over £6.5 million;
- more than 50 employees.

The Department for Business, Innovation & Skills has consulted on implementation of the Accounting Directive, but has proposed retaining the audit exemption thresholds for the small undertakings as part of the initial implementation. Even allowing for the fact that charities are dependent on public confidence and should be accountable to the public, the disparity between the charity and company law requirements is significant. We take the view that it would be desirable to maintain consistency between the charity asset threshold and the company law asset threshold, and so whilst seeking views on increasing the charity asset threshold from £3.26 million to £5 million, our preference is to retain it at the same level as the company asset threshold. If the level was to increase, the benefits to charities as a result of this proposal would also increase.

Monetised Costs and Benefits – Option 2: Raise the Charity Audit Threshold

Costs

Familiarisation costs: Although the majority of charities will not be affected by the change, it is conservatively assumed that under Option 2 all 200,000[2] charities' trustee boards will bear the costs of familiarisation with the new thresholds.

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[1] Trusted and Independent: Giving charity back to charities, Review into the Charities Act 2006, available here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/79275/Charities-Act-Review-2006-report-Hodgson.pdf

[2] There are approximately 160,000 registered charities, plus an estimated further 40,000 charities that are not registered but are regulated by the Charity Commission.

We have estimated that it would take one trustee an hour (best estimate) to read the details of the simple deregulation, perhaps check their charity's income with an accountant, and disseminate information to other board members. Trustees undertake their duties on a voluntary basis, but for the purposes of this impact assessment we have valued their time at £22.2 per hour. This is based on data from the Annual Survey of Hours and Earnings (ASHE) 2013, on the median gross hourly wage for 'Other managers'[3], including 30% non-wage costs and expressed in 2014/15 price terms.

The total transitional familiarisation costs are therefore estimated to be 200,000 x (£22.2 x 1) = £4.4m. This figure does not represent actual expenditure; rather it represents monetised voluntary effort.

Since familiarisation times can vary, depending on trustees' ability to check accounts and disseminate information quickly, low and high estimates are based on familiarisation time of 0.5 and 2 hours, respectively. This results in a low cost estimate of £2.2m (200,000 x £22.2 x 0.5) and a high cost estimate of £8.9m (200,000 x £22.2 x 2).

Search costs: It is expected that changing audit responsibilities may result in transitional costs to affected charities associated with finding an independent examiner.

It is anticipated that many charities affected by the regulatory change will continue to use their existing auditors to carry out the independent examination (all qualified auditors are also qualified to carry out independent examinations). In this case, search costs will be minimal: it is assumed that only an hour or two of trustee time will be required to negotiate an independent examination price with the existing auditor.

However, in cases where existing auditors are unable or unwilling to carry out an independent examination, or where charities choose to change providers, more trustee time will be required to search for and compare rates of independent examiners and come to an arrangement with the preferred choice.

As there is no available indication of what proportion of charities will change auditor as a result of now only needing an independent examination, it is conservatively assumed that on average a day (7 hours) of trustee time will be devoted to search and negotiation for <u>every charity</u> affected by the regulatory change.

With an estimated 3,800 charities affected by the regulations (see 'Benefits' section below), the total search cost is calculated as 3,800 x (£22.2 x 7) = £0.6m.

In the low search cost estimate, a smaller number of charities are affected by the regulations (see 'Benefits' section below), estimated at 3,140. The search costs are therefore estimated as 3,140 x (£22.2 x 7) = £0.5m. In the high cost estimate, we assume a higher number of charities affected by the regulation (4,130) and calculate cost as 4,130 x (£22.2 x 7) = £0.6m.

Total transitional costs are estimated at £4.4m + £0.6m = £5m (best estimate), or £2.7m (£2.2m + £0.5m) and £9.5m (£8.9m + £0.6m) in the low and high estimates, respectively. The assumptions taken in calculating high, low and best estimates of costs are summarised in the table below.

Table 1 – Summary of cost assumptions

	Familiarisation costs			**Search costs**			**TOTAL (£m)**
Estimate	Familiarisation time (hours)	Rate per hour	Charities affected	Search hours	Rate per hour	Charities affected	
High	2	£22.20	200,000	7	£22.20	4,130	**9.5**
Low	0.5	£22.20	200,000	7	£22.20	3,140	**2.7**
Best	1	£22.20	200,000	7	£22.20	3,800	**5.0**

Benefits

[3] Occupational category as used in Administrative Burdens Measurement Exercise Technical Summary: http://www.dti.gov.uk/files/file35995.pdf.

Ongoing cost savings: The proposed increase in both the income only and the income and asset audit thresholds will save around 3,800 registered and an unknown number of unregistered charities from the costs of having their accounts audited every year. These charities will then be required to have their accounts examined by an independent examiner. The independent examination that will take the place of the audit is less costly, leading to substantial annual cost savings for charities. The table below shows how different charities are affected depending on their income and asset band.

Table 2 – Effect of Policy by Charity Income and Asset Band

	Charity income (annual)			
Charity assets (total)	£0-£250k	£250k-£500k	£500k-£1m	£1m+
£0-£3.26m	No change: Independent Examination	No change: Qualified Independent Examination	Qualified Independent Examination instead of audit	No change: audit
£3.26m-£5m	No change: Independent Examination	Qualified Independent Examination instead of audit	No change: audit	No change: audit
£5m+	No change: Independent Examination	Qualified Independent Examination instead of audit	No change: audit	No change: audit

Charities with an annual income between £500,000 and £1 million (and assets of less than £3.26m)

The estimated average cost of an audit for these charities is £4,750. This is based on the figure for charities in the £0-£1mil income bracket from the Charity Financials Audit fee report, June 2014.[4]

An alternative audit cost for charities in this income band is estimated at £6,000 by the Charity Finance magazine.[5] Whilst this figure is used to calculate the higher net benefit estimate, the £4,750 is used as the best estimate because it provides the more conservative estimate of total benefits.

With the help of consultation with the Association of Independent Examiners, it is estimated that the average cost of an independent examination for charities in this income band is likely to be around £1,500 (with a range between £0 and £3,000). We have used a higher figure of £2,500[6] to arrive at a more conservative estimate of saving per charity. The resulting best estimated annual saving per charity is therefore £2,250 (£4,750-£2,500), with a high saving estimate of £3,500 (£6,000 - £2,500).

Charity Commission data shows there are roughly 3,770 registered charities in this income band, with around 630 of these with assets above £3.26m (and therefore still needing to audit accounts). We therefore expect that around 3,140 charities will move from audit to independent examination responsibilities, bringing the estimated total savings to between £7.1m (£2,250 x 3,140) per annum (best estimate), and £11.0m (£3,500 x 3,140) per annum (high estimate). It is assumed that the number of charities in this income band will remain relatively stable.

Charities with an annual income between £250,000 and £500,000 and assets worth more than £3.26 million.

There are over 6,600 registered charities in this income band, but the Commission's register does not record the value of a charity's assets.

[4] The figure is based on 1208 charities in this income bracket from data on the 'top' 5000 UK charities, where 'top' includes all charities with: income>£1.6mil **or** expenditure>£1.56mil **or** net assets>£3.2mil. It is assumed that the number of charities meeting these criteria with income below £500k is low due to the nature of the 'top' charity definition (i.e. the number of charities with income below £500k but expenditure>£1.56mil and/or net assets>£3.2mil is low). Available online at: http://secure.charityfinancials.com/reports.aspx

[5] In a survey of 136 charities, available online at: http://www.broomfield.co.uk/wp-content/uploads/2012/09/Charity-Finance-audit-survey-20123.pdf

[6] Previously accepted by the Charity Commission.

Using the same data sources as above, the typical cost of an independent examination for these smaller income charities will be around £1,000. An audit will cost around £2,500 plus an allowance for work involved in verifying assets, which will bring the cost up to around £3,500, giving a typical annual saving for each charity of £2,500 (£3,500 - £1,000). This far outweighs the transitional cost per charity (£22 + £155 = £177).

Whilst the precise number of charities in this income bracket with assets below £3.26m is unknown, previous informal consultation with the Charity Commission suggests that this could be around 10%. In estimating total net benefits (best estimate), we have therefore assumed that 10% or 660 charities in this income band have assets worth more than £3.26m, and therefore incur the savings associated with the regulatory change. We varied this assumption to 0% in the 'low' estimate, and 15% in the 'high' estimate.

The estimated total annual cost saving therefore rises by £1.6m (660 x £2,500) to £8.7m (best case). In the higher estimate of total benefits, the total number of charities affected is 4,130 (3,140 + 990) and the annual cost saving rises by £2.5m (990 x £2,500) to £13.5m.

In the low estimate of total net benefits, it has been assumed that no charities have assets above £3.26m, meaning none in this income band are affected and the total annual cost saving remains at £7.1m.

The assumptions taken in calculating high, low and best estimates of benefits are summarised in the table below.

Table 3 – Summary of benefit assumptions

	Savings - £500k-£1m income band				**Savings - £250k-£500k income band**				**TOTAL (£m)**
Estimate	Audit cost (£)	IE cost (£)	Saving (£)	Charities affected	Audit cost (£)	IE cost (£)	Saving (£)	Charities affected	
High	6,000	2,500	3,500	3,140	3,500	1,000	2,500	990	**13.5**
Low	4,750	2,500	2,250	3,140	3,500	1,000	2,500	0	**7.1**
Best	4,750	2,500	2,250	3,140	3,500	1,000	2,500	660	**8.7**

Table 4 – Summary of costs and benefits and net present value (best estimate)

Annual profile of monetised costs and benefits (£'000s, constant prices)											
	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	**Total**
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	
Description of cost											
Familiarisation Costs - Charities	4.4	0	0	0	0	0	0	0	0	0	
Search Costs - Charities	0.6	0	0	0	0	0	0	0	0	0	
Discount adjustment	1.0000	0.9662	0.9335	0.9019	0.8714	0.8420	0.8135	0.7860	0.7594	0.7337	
Present Value Total Cost	5	0	0	0	0	0	0	0	0	0	**5**
Description of benefit											
Annual recurring benefit (cost saving) - Charities	0	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	
Discount adjustment	1.0000	0.9662	0.9335	0.9019	0.8714	0.8420	0.8135	0.7860	0.7594	0.7337	
Present Value Total Benefit		8.4	8.1	7.9	7.6	7.3	7.1	6.9	6.6	6.4	**66.3**
Net Present Value	-5	8.4	8.1	7.9	7.6	7.3	7.1	6.9	6.6	6.4	**61.3**

Non-monetised Costs/ Other Considerations

There is the potential that with fewer charities obliged to subject their accounts to a full audit, a rise in charity fraud will result. However we have not seen any evidence to support this contention. Any increased scope for fraud will be mitigated by the qualified independent examination that will provide a proportionate level of scrutiny and transparency, with accounts examined by a person with a professional accounting qualification. Further, the accounts of registered charities (with incomes over £25,000) will continue to be available to the public on the Charity Commission's website and both registered and unregistered charities will still be legally required to send a copy of their accounts to anybody that asks for them. These mean that charity fraud will remain unlikely, and associated costs low. However, we will monitor whether the move to qualified independent examination for these charities has any impact on levels of fraud or abuse.

An associated cost of the regulatory change may also arise in a decline of public trust in charities. This could result in a fall in donations. However, smaller charities not currently subject to audit do not appear to suffer from issues of public confidence: a survey by Ipsos Mori[7] found that 47% of people disagreed when asked if they trusted big charities more than smaller charities, compared to only 37% who agreed.

Equivalent Annual Net Cost to Business (EANCB)

The net cost to business per year (equivalent annual net cost to business in 2009 prices) is estimated at **- £5.61m** using the BRE online impact assessment calculator and the above cost and benefit figures.

Summary and preferred option with description of implementation plan

The Government's preferred option is Option 2, to increase the thresholds that require a charity to have its accounts audited to:

- an income of more than £1 million; or
- assets worth more than £3.26 million and an income of more than £500,000.

These measures will require secondary legislation in the form of a negative statutory instrument to amend the relevant financial thresholds in the Charities Act 2011 and will be subject to the availability of Parliamentary time.

If Parliamentary process is followed, the new thresholds should come into full effect on 6 April 2015, the next Common Commencement Date (CCD). This means charities with a financial year ending on or after 6 April 2015 will only have to have their accounts audited if they sit above the new thresholds described.

All charities will need to familiarise themselves with the new measures as reflected in the familiarisation costs detailed above. Therefore, if Parliament approves the changes, we will work with the Charity Commission to prepare and publish appropriate guidance.

The changes will be reviewed three years after implementation, which will consider the effects and savings produced by the new thresholds.

These measures are in scope of One-In, Two-Out.

[7] Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284715/ptc_ipsos_mori_2012.pdf