

Materiality and the Charities SORP - Discussion Briefing

Prepared by: CIPFA and Reviewed by the Charities SORP-making body, June 2021

Purpose of the briefing paper

To assist the engagement strands and SORP Committee with their reflections on the current approach to materiality within the SORP and to undertake a problem-solving exercise to identify:

- the option(s) for changing what the SORP says about materiality, if any and if so,
- a preferred option with a recommendation as to what the change to the SORP should be, if any.

Reflection - what does the SORP say about materiality?

The current Charities SORP (FRS 102) provides the following explanation of “materiality”: within Module 3 Accounting Standards, Policies, Concepts and Principles, including the adjustment of estimates and errors:

3.2 *Materiality relates to the financial information provided in the accounts and an item is material when its omission or misstatement could influence the economic decisions that users make on the basis of those accounts.*

Further guidance on materiality is included in Module 3 as follows:

3.15 *FRS 102 and this SORP set certain accounting treatments and disclosures in the context of their materiality. Charities, in preparing their accounts, should therefore give particular consideration to material items or transactions as their omission or misstatement could influence economic decision-making by the user of the accounts and any assessment of the stewardship of charitable funds. An omission or misstatement of a material item may result in the accounts failing to give a true and fair view.*

3.16 *Materiality needs to be considered in the context of the accounts and depends on:*

- *the size of the item or error;*
- *the nature of the item or error;*
- *the impact of its omission or misstatement on the reported gross income or total expenditure and net assets; and*

- *the impact of its omission or misstatement on particular analysis headings within the statement of financial activities, balance sheet and, where applicable, statement of cash flows and on the disclosures made in the notes to the accounts.*
- 3.17 *Charities should only disclose accounting policies that apply to material items or transactions. Charities should avoid providing unnecessary information for non material items or transactions.*
- 3.18 *Although FRS 102 and this SORP need only be applied to material items or transactions, it is inappropriate to make, or leave uncorrected, immaterial departures from this SORP to achieve a particular presentation of an entity's financial position, financial performance or cash flows.*
- 3.19 *This SORP specifies when a charity must always consider a particular item or transaction material, for example the disclosure of related party transactions. Also, as a matter of emphasis, SORP modules may make particular reference to materiality.*

Additionally, the Glossary in Appendix 1 contains the following on materiality:

Material or materiality *is an accounting test of what elements of information should be given in a particular set of accounts (financial statements). Omissions or misstatements of items are material if they could individually or collectively influence the economic decisions of users taken on the basis of the accounts.*

Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor in identifying whether it is material.

Immaterial information will need to be excluded to avoid clutter that impairs the ability to understand other information provided. Materiality is not capable of general mathematical definition, as it has both qualitative and quantitative aspects.

Materiality is identified from a combination of factors, rather than any one in particular. The principal factors normally taken into account are:

- *the item's size judged in the context of the accounts as a whole and the other information available to users that would affect their evaluation of the accounts (this includes, for example, considering how the item affects the evaluation of trends and similar considerations); and*
- *the item's nature in relation to:*
 - *the transactions or other events giving rise to it;*
 - *the legality, sensitivity, normality and potential consequences of the event or transaction;*
 - *the identity of the parties involved; and*
 - *the particular headings and disclosures that are affected.*

If there are two or more similar items, the materiality of the items in aggregate as well as of the items individually needs to be considered.

The person preparing the accounts is responsible for deciding whether an item is material. This process may result in different materiality considerations being applied, depending on which

aspect of the accounts is being considered. For example, there is a requirement for a high degree of accuracy in the case of certain disclosures such as trustees' remuneration and expenses, which will override normal materiality considerations.

With respect to 3.19 above, one SORP module (module 9) specifies items or transactions that must be considered material:

9.3 A transaction involving a trustee or other related party must always be regarded as material regardless of its size.

All other SORP references to materiality (e.g. a reference to materiality within a paragraph on disclosure) require the preparer to apply judgement in determining whether the item or transaction is material.

What is the reporting difference between 'all' and 'larger' charities?

There are no specific requirements for larger charities with respect to materiality within the current SORP. Given the tentative recommendation for the next SORP to have three tiers for reporting, as currently drafted the definition of materiality in the SORP would be the same for all charities. Materiality is applied in the context of the reporting charity.

FRS 102 and the scope for changing the SORP to accommodate a different approach to materiality

The explanation of materiality per the SORP closely matches the explanation per FRS 102. Materiality is explained in FRS 102 as follows:

2.6 Information is material – and therefore has relevance – if its omission or misstatement, individually or collectively, could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. However, it is inappropriate to make, or leave uncorrected, immaterial departures from this FRS to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

FRS 102 contains the following requirements with respect to materiality:

3.15 An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.

3.16 ... If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. ...

3.16A ... *An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.*

Engagement strand feedback during the exploration stage

Larger Charities Engagement Strand Perspective

The Larger Charities engagement strand made the following comments:

In feedback from both the *user of the accounts perspective* and the *user of the SORP/preparer of accounts perspective*, only one point was noted with respect to materiality:

The Larger Charities engagement strand commented that providing a guide on materiality would help very large charities to be clear about what does not need to be included in the accounts and would therefore support better readability and brevity.

Observations from the SORP Committee:

At its meeting held on 23 February 2021, the Charities SORP Committee expressed the view that it was difficult to provide guidance on materiality and particularly to be able to assist charities with issues which arise, for example, by quantifying thresholds which are material to a particular charity. Further, it was noted that there is also an audit perspective to this topic.

Relevant SORP research findings

The 2016 SORP consultation exercise identified some commentary on materiality.

Two respondents called for greater clarification around the concept of materiality when applied to disclosures which are 'musts'. The stringent application of the term 'must' was seen as contributing to an increasing amount of disclosures and contributing to overly long accounts.

We would welcome further clarity in the guidance section on materiality as to items that 'must' be disclosed. Whilst the Charity SORP states that these terms are to be 'applied to material transactions' (paragraph 33) we fear that without clearer guidance auditors will tend to err on the side of caution. This is likely to lead to unhelpful clutter in the accounts. A practical example for us is the disclosure of redundancy costs set out in 9.27 where a charity 'must state' the total amount for the reporting period and the nature of the payment. (Cancer Research UK, No.142)

What needs to be done now?

Step 1- Making the case for change - a 'basis for conclusions'

A need for change in relation to materiality has come through clearly from one engagement strand and SORP Committee discussions to date. At this stage, clarity is required as to what changes are required and the reasons that support these changes. Without a case for change, no change will be considered because its rationale cannot be explained to those affected.

Step 2 - Advising the change required to the SORP

Having made the case for change, the detailed changes required to the SORP need to be set out. Consideration should be given in as much detail as possible for the requirements regarding materiality and what else the SORP should include about materiality – for example, glossary entries. If no detail is given, the conclusion drawn is that the detail is left wholly to the discretion of the SORP Committee and SORP-making body.

Undertaking an assessment of the impact (savings or costs on the preparer and benefits or disadvantages to the reader)

The FRC will require an impact assessment but until the implications of change are worked through the SORP framework, the impact is unlikely to be clear and so this will be considered at the drafting stage of the process.

Step 3 – Recommendation

The case made by each strand or combination of strands will inform the deliberations of the SORP Committee and so there needs to be a clear recommendation.

The SORP Committee will be having its own discussion about what needs to be done and taking the evidence and views from the process, the Committee will settle on a recommended approach for drafting the SORP based on the evidence presented.