Application of Materiality to Financial Statements

ICAEW welcomes the opportunity to comment on the draft IFRS Practice Statement *Application of Materiality to Financial Statements* published by the International Accounting Standards Board (IASB) on 28 October 2015, a copy of which is available from this link.

This response of 12 February 2016 has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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MAJOR POINTS

Welcome for the exposure draft

1. We welcome the exposure draft (ED) *Application of Materiality to Financial Statements*. We believe that the proposed Practice Statement would usefully draw together and explain existing requirements and help preparers make and defend decisions on materiality.

Suggested improvements

2. We have, however, identified a number of points in the draft where we think that there is scope for improvement. In particular, we think it would be more helpful for the Statement to be structured in a way that reflects the thought processes that preparers would have to go through, and the considerations that they would have to take into account, in making decisions on materiality. A number of the examples could be improved (we comment on these below). And it would also be helpful if the Statement were rather shorter and more succinct, so as to be more useful; we suggest some possible deletions below.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Form of the guidance

A Practice Statement is not a Standard. The IASB's reasoning for issuing guidance on applying the concept of materiality in the financial statements in the form of a non-mandatory Practice Statement is set out in paragraphs BC10–BC15.

(a) Do you think that the guidance should be issued as non-mandatory guidance? Why or why not?

(b) Do you think that a Practice Statement is the appropriate form for non-mandatory guidance on applying the concept of materiality? Why or why not? If not, what alternative(s) do you propose and why?

3. We believe that the proposed Practice Statement would usefully bring together, highlight and explain requirements that are already contained in standards. We do not think that it is necessary to introduce fresh requirements on this subject. The non-mandatory guidance format is therefore an appropriate one and has the practical advantage that the statement can be issued without the long drawn-out process necessary for issuing new requirements in standards. As such, however, it should aim to be as useful as possible to preparers (and other interested parties) who need to make decisions about materiality in practice.

Q2: Illustrative examples

Do you find the examples helpful in the [draft] Practice Statement? Do you think any additional practical examples should be included? If so, what scenarios should the examples address? Please be as specific as possible and explain why those example(s) would be helpful to entities.

4. We comment below on specific examples in the draft; we believe that a number of them could be improved. The Financial Reporting Council's *Corporate Reporting Review* for 2015 gives a useful real-life example of how a materiality problem was addressed, and the IASB may find it helpful to consider this.

Q3: Content of the [draft] Practice Statement

The [draft] Practice Statement proposes guidance in three main areas:

(a) characteristics of materiality;

(b) how to apply the concept of materiality in practice when presenting and disclosing information in the financial statements; and

(c) how to assess whether omissions and misstatements of information are material to the financial statements.

It also contains a short section on applying materiality when applying recognition and measurement requirements.

Please comment on the following and provide any suggestions you have for improving the [draft] Practice Statement:

(a) Do you think that any additional content should be included in the Practice Statement? If so, what additional content should be included and why?

(b) Do you think the guidance will be understandable by, and helpful to, preparers of financial statements who have a reasonable level of business/accounting knowledge and IFRS? If not, which paragraphs/sections are unclear or unhelpful and why?

(c) Are there any paragraphs/sections with which you do not agree? If so, which paragraphs/sections are they and why?

(d) Do you think any paragraphs/sections are unnecessary? If so, which paragraphs/sections are they and why?

(e) Do you think any aspects of the guidance will conflict with any legal requirements related to materiality within your jurisdiction, or a jurisdiction in which you file financial statements?

5. As stated above, we think it would be more helpful for the Practice Statement to be structured in a way that reflects the thought processes that preparers would have to go through, and the considerations that they would have to take into account, in making decisions on materiality. It would also be helpful if the Statement were rather shorter and more succinct.
6. On Question 3(a), it would be useful to add guidance emphasising that it is pointless to disclose accounting policies for items that do not appear in the financial statements either for the current year or as comparatives. This point could be added at paragraph 27(a) and/or at paragraph 34 of the ED (see below).
7. On Question 3(b), we consider that the guidance, although it could be improved, will be useful for preparers, particularly as it should help them to explain to regulators why immaterial items have been omitted from the financial statements.
8. On Questions 3(c), (d) and (e), see our detailed comments below.

Q4: Timing

The IASB plans to issue the Practice Statement before the finalisation of its Principles of Disclosure project.

The IASB has tentatively decided to include a discussion on the definition of materiality, and whether there is a need to change or clarify that definition within IFRS, in the Discussion Paper for its Principles of Disclosure project (expected to be issued early in 2016). Nevertheless, the IASB thinks that to address the need for guidance on the application of materiality, it is useful to develop the Practice Statement now.

The IASB does not envisage that the discussion about the definition of materiality or any other topics in its Principles of Disclosure project will significantly affect the content of the Practice Statement. Nevertheless, the IASB will consider whether any consequential amendments to the Practice Statement are necessary following the completion of the Principles of Disclosure project. Do you agree with this approach?

9. We agree that the Practice Statement should be issued before the Principles of Disclosure project is completed.

Q5: Any other comments

Do you have any other comments on the [draft] Practice Statement? As mentioned in Question 4, a discussion about the definition of materiality will be included in the Discussion Paper in the Principles of Disclosure project, so the IASB is not asking for comments on the definition at this time.

10. See our detailed comments and other drafting points below.

DETAILED COMMENTS

Ongoing disclosure obligations

11. Paragraphs 5 and 6 suggest that the meaning of 'materiality' for the purposes of ongoing market disclosure obligations is consistent with its use in financial reporting. We do not think that this is correct and we suggest that the point should be deleted. Such obligations differ among jurisdictions, and in those jurisdictions for which we are aware of the requirements the test is applied differently in the two contexts.

Primary users

12. We support the proposed amendment to the *Conceptual Framework* referred to in note 5, inserting the word 'primary' before 'users' in the framework's definition of 'materiality', and in this response we assume that the amendment will be made. We therefore assume that, wherever the ED refers to 'users', the IASB has in mind 'primary users'. We suggest that this should be clarified at a number of places in the draft; specifically, 'primary' should be inserted before 'users' in the last line of paragraph 10 and in lines 3 and 6 of paragraph 12.

Nature and magnitude

13. The definition of materiality quoted at paragraph 7 is said to come from the *Conceptual Framework for Financial Reporting* ED, which allegedly refers to 'the nature and magnitude, or both, of the items'. This is a misprint for 'nature or magnitude …'. However, the definitions in IAS 1, *Presentation of Financial Statements*, and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, do indeed refer to 'size and nature' before then referring to size or nature or both. There is an important substantive point here. In our view, it is nearly always necessary to consider both the nature **and** magnitude of items in deciding questions of materiality. For example, the number of red cars produced by a car manufacturer may be very large and their value may be very high, but information about this would not be regarded as material because the information is inherently insignificant. Also, what constitutes a significant magnitude for this purpose depends on the nature of the item. A material amount in relation to directors' remuneration disclosures, for example, would usually be much smaller than for other items in the financial statements because of the importance of this information for stewardship purposes.

14. We therefore suggest that the definition in the *Conceptual Framework* should be amended to refer to 'the nature and magnitude of the items', and there would be a resulting effect on the Practice Statement. However, the issue should be discussed in the Practice Statement in any case. If the *Framework* is not amended, then the Practice Statement should be in line with the standards rather than with the *Framework*.

Entity accounts

15. We noted in our response to the *Conceptual Framework* ED (ICAEW Rep 154/15) that IFRS does not really address the question of entity accounts. This issue arises again in the discussion of users and their needs in the present ED (paragraph 13 onwards). It would be helpful if the Practice Statement were to discuss it.

Qualitative and quantitative aspects

16. Paragraph 27 purports to give examples of occasions when it may not be helpful to consider quantitative aspects in assessing materiality. As noted above, we consider that quantitative aspects (or questions of 'magnitude') are nearly always relevant, and so we are doubtful about the purpose of this paragraph. Nor are we convinced that magnitude is irrelevant to judging materiality for the two examples given in this paragraph.

17. The specific example at paragraph 27(a) does not seem to relate well to the point at issue, which is whether disclosure of a particular accounting policy would be necessary to understand the financial statements. A better example of a disclosure that would **not** be necessary would be an accounting policy for items that do not appear in the financial statements either for the current year or for comparatives. Such a disclosure would be immaterial because the quantity of the relevant items is zero.

18. The specific example currently in paragraph 27(a) is trying to make two distinct points. First, it makes the point that the wording of requirements in IFRS will usually have to be amended in order to provide a helpful accounting policy note. This is partly because the requirements are not drafted to be used as accounting policy notes, but also – as the ED observes – because it may be useful to explain how the requirement is being applied by the entity. However, this has nothing to do with materiality. Second, it suggests that such a disclosure is potentially immaterial; it is not clear why this is suggested, and if this example is retained we recommend that the point should be explained. We suspect that, if such a disclosure were indeed immaterial, quantitative aspects would be relevant to that judgement.
19. Paragraph 27(b) notes that 'in considering the materiality of uncertainties and contingencies, the monetary amounts involved are not always known or may have a potentially wide range of outcomes.' This is not, in our view, an example of a situation where 'considering quantitative aspects may not be helpful'. Indeed, the uncertainty of the amounts involved may strengthen the case for disclosing an item on the grounds of its potential (but unknown) magnitude. Quantification (or magnitude) is still likely to be relevant to materiality judgements even when the quantities involved are uncertain or changeable.
20. It would be helpful at paragraph 28 to include an example that is material because of its relevance to stewardship issues, eg, directors' remuneration.
21. We are not convinced that the example at paragraph 28(b) would in fact be material. We think that it would stretch the concept of materiality unduly to require disclosure of items that are insignificant now on the grounds that corresponding amounts in the future are expected to become material if management's current ambitions are realised.
22. We also think that a better example could be found for paragraph 28(c) as transactions with related parties on special terms are by no means 'rare or unusual', or perhaps the example could be kept but it could be explained better why it would be material.

Immaterial information

23. At paragraph 34, disclosing accounting policies for items that do not appear in the financial statements might again be a good example.

Aggregation

24. The logic of paragraph 39 may not be obvious to readers as the examples illustrate how in different situations different conclusions may reasonably be drawn about the effects of aggregation on materiality. It might be easier to understand this paragraph if the examples were restricted to instances where aggregation obscures material information.
25. We think that the materiality of the example at paragraph 39(a) could not be decided without additional information not given in the ED, and we therefore suggest that a better example should be found.
26. At paragraph 39(b), the use of the word 'speculative' seems to indicate that there is something suspicious about the transaction that makes it especially in need of disclosure. Speculative transactions are of course a normal part of business activity and we suggest that care should be taken to avoid any insinuation that they are not.
27. We are not sure what point the example at paragraph 39(c) is intended to make and we suggest that it should be deleted.

Notes to the accounts

28. The discussion at paragraphs 45 to 48 implies that there are two levels of materiality: one for what should appear on the face of the accounts and another for what should be disclosed in the notes. It is not clear to us that there are currently two concepts in the *Conceptual Framework* or in IAS 1 (eg, see paragraph 112) or IAS 8, and we do not think that there should be. If the IASB believes that there are two concepts, it would be important to clarify this and to discuss how the two levels of materiality differ.

29. The second sentence of paragraph 47 does not quite say what it is intended to. It needs to say something like: 'Information that is material to the financial statements, but that does not require separate presentation in the primary financial statements on grounds of materiality, may be provided in the notes.' However, this depends on the IASB's response to our point made in the previous paragraph.

Disclosures specified in IFRS

30. The discussion at paragraphs 50 and 51 is a bit too black-and-white; it implies that the only options are to make a disclosure or not to make it. In practice, there are usually a range of options as to how fully or helpfully something could be disclosed or explained. This may be best discussed in the IASB's Principles of Disclosure project.
31. It would be helpful to clarify that the examples at paragraph 53 relate to the issues discussed at paragraphs 50 to 52, and not just at paragraph 52 as the reader may assume. Also, it is not clear what paragraph 53(d) is an example of; it appears to introduce additional points for consideration.

Recognition and measurement

32. It would be helpful to have some discussion of the degree of precision required for estimates in deciding whether the effect of recognition and measurement requirements is material.

Current period misstatements

33. We suggest that the last two sentences of paragraph 71 should be deleted. What are described here are simply the effects of double-entry bookkeeping rather than the pervasiveness of a misstatement.

Prior period errors

34. An issue that is not discussed in the Practice Statement, but which can cause problems in practice, is the question of whether a prior period error that would have been material in the context of the prior period, but is immaterial in relation to the current period, should be disclosed in the current period's accounts. We do not suggest that the Practice Statement should discuss this, but it would be helpful to address it in an Interpretation of IAS 8 or when IAS 8 is next revised.

Misstatements made intentionally to mislead

35. At paragraph 77, the quotation from IAS 8 refers to 'errors made intentionally'. We suggest that IAS 8 should be amended as the normal use of the word 'error' implies that it is unintentional.
36. The draft guidance is aimed primarily at preparers to help them make judgements on materiality so as to provide useful information. But parts of paragraphs 78 and 79 appear to be addressed to preparers who have the intention to mislead. We suggest that these paragraphs should be redrafted to avoid giving this impression.

OTHER DRAFTING POINTS

37. In the first line of paragraph 3 it would clarify the meaning to insert 'required' before 'information'.
38. Note 5: 'user' is a misprint for 'users'.
39. Paragraph 11: in the last sentence, 'Similarly' is wrong; 'Conversely' would be better.
40. Also at paragraph 11, it would be helpful to specify the requirements in IFRS that are being relied on.
41. Paragraph 12: we suggest that 'and at the end of' should be inserted after 'during'.
42. Also, it is not clear what the last sentence of paragraph 12 is getting at, and we suggest that it should either be clarified or deleted.

43. We suggest that ‘in relation to the entity’ is added at the end of both sentences in paragraph 14.
44. It would be helpful for the point at the end of paragraph 19 – that ‘information would usually be expected to be material if it is relevant to … a significant class of primary user’ – to be made at paragraph 17 too. Alternatively, paragraph 17 could be deleted except for the first and third sentences, which could be moved to the start of paragraph 19.
45. At paragraph 51, it would be useful to cross-refer to paragraph 15 of IAS 1.
46. Paragraph 53(b): it would be helpful to clarify the last sentence of this sub-paragraph.
47. We suggest that paragraph 66 would be better placed after paragraph 63.
48. Paragraph 79(b): in the second line, ‘to’ should be deleted.