STAFF PAPER

15 June 2016

CMAC / GPF Meeting

Project	**Materiality**		
Paper topic	Materiality Judgement Process		
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Purpose of this session

1. The purpose of this session is to obtain advice and comment from CMAC and GPF members on a draft 'Four-step Approach' for making materiality judgements when preparing a financial report.

2. To facilitate these discussions, we include two examples in Appendix A for CMAC and GPF members to discuss during the breakout session.

Structure of this paper

3. The paper is structured as follows:

   (a) introduction;

   (b) draft Four-step Approach;

   (c) questions for the CMAC and GPF members; and

   (d) appendix A—examples for discussion.

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The+organisation/Advisory+bodies/CMAC/.aspx
Information about the Global Preparers Forum (GPF) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/Pages/Global-preparers-forum.aspx

Introduction

4. IAS 1 *Presentation of Financial Statements* requires management to apply materiality judgements when preparing an IFRS financial report. Paragraph QC11 of the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) defines materiality:

> Information is material if omitting it or misstating it could influence decisions that users[1] make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity specific aspect of relevance based on the nature and magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.

5. In October 2015, the Board published an Exposure Draft *IFRS Practice Statement: Application of Materiality to Financial Statements* (draft *Practice Statement*). The objective of the draft *Practice Statement* is to assist management in applying the concept of materiality to general purpose financial reports prepared applying IFRS Standards.

6. Many stakeholders, in their feedback on the draft *Practice Statement,* asked the Board to describe more clearly the judgement process of applying materiality.

7. In response to these requests, we have developed a draft Four-step Approach, including a description of factors we propose management consider when applying materiality. We intend to recommend to the Board that it includes this in the *Practice Statement*.

Four-step Approach

8. Applying materiality judgements is part of the process of preparing a financial report. In developing the following Four-step Approach, we have considered how materiality

[1] Paragraph 2.11 of the Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* (*Conceptual Framework* ED) proposes modifying this definition by including the word 'primary' before the word 'user'. Consequently, in this paper we have referred to 'primary users'.

fits into this process and identified factors that we think management can apply in making a materiality judgement.

Four-step Approach in applying materiality judgements in preparing a financial report

9. Management can consider the following four steps in applying materiality judgements to preparing a financial report:

   (a) Step—1 identify the primary users and their information needs.

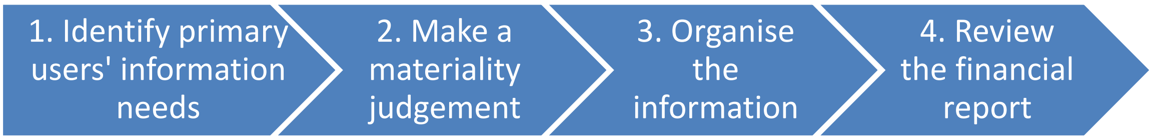
   (b) Step—2 assess particular items of information about the entity's financial performance and financial position to decide whether the information is material in the context of the financial report as a whole. In making this assessment consider the impact on the entity's financial performance and financial position of the broader circumstances / environment in which the entity is operating.

   (c) Step—3 organise material information within the financial report. Organising this information will involve, for example, determining where the information should be provided; separately on the face of a primary financial statement[2], or in the notes to the financial report.

   (d) Step—4 'step back' and review the entire draft financial report to determine, based on management's cumulative knowledge and experience of the entity, whether all material information has been included in the financial report, and whether the financial report gives a balanced picture of the entity's financial performance and financial position. This review includes considering the cumulative materiality of information that was initially assessed as not material in itself when assessed individually in Step 2.

10. The following diagram summarises these four steps:

[2] The terms 'primary financial statements' is expected to be defined as part of the *Principles of Disclosure* project. For this paper, the primary statements are the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows. In other words, the primary financial statements comprise the financial statements excluding the notes.



Step 1—identify primary users' information needs

11. Whether information is material is assessed by considering whether including that information could influence primary users' economic decisions. The first step involves:

(a) identifying the primary users of the entity's financial report; and

(b) identifying primary users' information needs and their expectations.

12. The *Conceptual Framework* identifies the primary users of an entity's general purpose financial report as the existing and potential investors as well as lenders and other creditors of the entity.

13. The *Conceptual Framework* explains that primary users need information to help them assess the prospects for future net cash inflows to an entity[3]. For this assessment, the *Conceptual Framework* explains, the primary users need information about the resources of the entity, claims against the entity and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to manage the entity's resources. Consequently, when assessing the information needs of the primary users, management considers what information, about the entity and its circumstances, will meet those information needs and thus help the primary users assess the entity's prospects for future net cash inflows.

14. The *Conceptual Framework* notes that an entity may have different subsets of primary users, however an entity's financial report is not expected to meet all information needs of all of the entity's primary users. The financial report should provide information that meets the common information needs of a broad range of primary users.

[3] Paragraph 1.3 of the *Conceptual Framework* ED proposed to add 'and their assessment of management's stewardship of the entity's resources' to highlight the role that information plays in helping primary users' assessment of stewardship.

15. Much of the primary users' common information needs will be consistent from one entity to another, for example, information about revenue, profit, and cash flows from operations. However, some common information needs for an entity's primary users will be specific to that entity.

16. Management should draw on their knowledge of the primary users' information needs and expectations; relevant sources to consider will include:

    (a) past disclosures by the entity. How have past communications, such as interim reports, analysts' briefings or trading statements, created expectations?

    (b) macroeconomic information about the economy, and the industry sector in which the entity operates. Although materiality is an entity-specific assessment, general economic- and industry-sector data can shape primary users' expectations.

Step 2—make a materiality judgement

17. Having identified the entity's primary users and the primary users' information needs and expectations, management assesses information about the entity's financial performance and financial position to determine which information is material and thus should be reported in the financial report. The requirements in IFRS Standards are the starting point for identifying what information should be assessed; these reflect the Board's conclusions of the information that it expects to meet the needs of a broad range of primary users.

18. In making the materiality assessment, management would need to not only draw on their knowledge of the entity but also to consider the potential impact of broader environmental factors. These factors could include changes in the entity's industry sector, the macro-economic environment, the impact of climate change, etc.

19. The following table describes some factors that management may find helpful in making materiality judgements about particular items of information:

Materiality Judgement Process

Quantitative factors

(a) is the item, or the change in the item, that the information describes large or small in the context of a key measure of the entity, or significantly larger or significantly smaller than a broad range of primary users would expect for the entity?

- key measures might include net profit, growth in profit, revenue, etc.

(b) is the information inconsistent with primary users' expectations for the entity?

- for example an unexpected change in a trend, including turning a profit to a loss, or an unexpected change in R&D focus for a technology company

Entity-specific qualitative factors

(c) does the information tell the primary user that the entity has not complied with laws, regulations, and contractual terms, including covenants and that non-compliance has consequences for the entity's financial performance and financial position?

(d) is the information about a related-party transaction, such as management compensation?

(e) has similar information, historically, either confirmed or changed primary users' view of the entity? Have primary users regularly asked for this information?

Environmental qualitative factors

(f) does the information reflect changes in the entity's industry, the wider economy or the environment in which it operates that primary users would expect to affect the entity's financial perofrmance or financial position, or the risks the entity is exposed to?

Step 3—organise the information

20. Management prepares the financial report including all material information identified. In preparing the financial report, management seeks to organise the information in a way that communicates material information efficiently and effectively.

21. IAS 1 describes the basic structure of the financial report. However, IAS 1 allows management to exercise judgement when deciding how best to communicate information.

22. The decisions management makes when organising the material information in the financial report include:

    (a) what material information to present on the face of the primary financial statements;

    (b) what material information to include in the notes to the financial report; and

    (c) in what order to present the notes to the financial report.

23. Materiality is one of the factors management considers when organising the information in the financial report. The forthcoming *Principles of Disclosure* Discussion Paper will discuss other factors to consider.

24. Although information that is not material may be included in a financial report, IAS 1 requires that an entity shall not reduce the understandability of its financial report by obscuring material information with information that is not material. Consequently, when organising the information in the financial report, management ensures that material information is not obscured.

Step 4—review the financial report

25. Management reviews the draft financial report to determine, based on management's cumulative knowledge and experience of the entity, whether all material information has been included in the financial report and with appropriate prominence so that the financial report gives a balanced picture of the entity's financial performance, financial position.

26. This review gives management the opportunity to step back and consider the cumulative materiality of information that was initially considered not material when assessed individually during the earlier stages of preparation. This includes identifying links between a particular piece of information and other pieces of information, which individually may appear immaterial, but collectively are material.

27. Conversely, the step back assessment might lead management to conclude that information that was initially identified as material is not material.

Questions for CMAC and GPF members

Questions for CMAC and GPF members to discuss in the breakout sessions
1. Do you think the draft Four-step Approach described in paragraphs 9 to 27 will help management identify material information to include in the financial report? i) where do you think more guidance is needed, and what do you think that guidance should say? ii) do you think applying the guidance will appropriately identify material information? If not, what do you think needs to change, and why? 2. Do you think that draft Four-step Approach could also help management identify immaterial information to exclude from the financial report? i) if not, what additional guidance do you think is needed to help identify whether information is not material and thus could be excluded from the financial report? 3. The examples included in Appendix A are provided as a focal point to help CMAC and GPF members answer the questions above.

Appendix A – Materiality examples for CMAC / GPF discussion

A1. Testing the application of the draft Four-step Approach in a classroom scenario is difficult because of the need to draw on a wide range of facts and circumstances when making a materiality judgement. Consequently, in considering the following two examples, rather than asking you to apply the Four-step Approach we ask you to:

a. consider what information you think should be assessed / what questions should be asked to determine whether:

  i. all material information has been included in the example disclosures; and

  ii. any immaterial information has been included; and

b. compare the information you think should be assessed / questions that should be asked with the materiality judgement factors presented in the draft Four-step Approach to identify additional factors, or changes to the factors included.

Example 1 Tax reconciliation note

A2. The following is an example of a typical tax reconciliation note.

	20X5	20X4
	'000	'000
Amounts recognised in profit or loss		
Current income tax:		
Current income tax charge	1,418	1,715
Adjustments for current tax from previous year as a result of the tax audit conducted during the year	-122	-55
Deferred income tax		
Current year deferred tax	175	-385
Deferred tax reclassified from equity to profit or loss	47	-
Income tax expense reported in the statement of profit or loss	**1,518**	**1,274**

Amounts recognised in OCI		
Deferred tax on the following items recognised in OCI during in the year		
Revaluation of property, plant, and equipment	200	-11
Remeasurement of defined benefit liability (asset)	25	-
Foreign operations- foreign currency translation differences	-117	-
Hedge of net investment in foreign operations	66	-
Cash flow hedges	50	145
Deferred tax recognised in OCI	**224**	**134**

Reconciliation of tax expense to accounting profit		
Accounting profit from ongoing operations, before tax	13,885	11,100
Profit/ (loss) from discontinued operations, before tax	266	-241
Accounting profit before income tax	**14,151**	**10,859**
At the entity's statutory income tax rate of 25%	3,538	2,715
Adjustments for current income from previous years as a result of the tax audit during the year	-122	-55
Government tax-exempt grants	-395	-302
Use of previously unrecognised tax losses	-392	-112
Non-deductible expenses for tax purposes		
Impairment of goodwill	75	-
Contingent consideration remeasurement	134	-
Other non-deductible expenses	13	-
Effect of different tax rates in foreign countries	-1,529	-1,197
Tax incentives in foreign countries	-657	-203
Other	275	190
At the effective income tax rate	940	1,036
Income tax expense reported in the statement of profit or loss	1,518	1,274
Income tax attributable to discontinued operations	-578	-238
	940	**1,036**

Example 2 Impact of climate change risks on financial report

A3. Some respondents to Board's 2015 Agenda Consultation proposed that the Board add a project to its agenda on the impact of climate change risks on IFRS financial statements. Some of those stakeholders were concerned that 'there is a need to assess whether companies' exposure to increasingly stringent climate-related regulations, and the physical impacts from climate change could result in foreseeable losses / impairments / liabilities that should be reflected in companies' financial statements'[4].

A4. Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board, in a speech on 29 September 2015[5], noted 'three broad channels through which climate change can affect financial stability'. Mr Carney went on to list these as physical risks, liability risks and transition risks.

A5. Mr Carney's remarks were to an audience at Lloyd's of London, and reflect what these risks mean for insurers. For entities operating in other industries, these risks could be reframed; physical risks could be thought of as the direct physical effects of climate change, such as damage to a factory by a hurricane. Liability risks could be thought of in terms of the indirect consequences of climate change, for example loss of revenues because a major customer's operations have been disrupted by climate change. Mr Carney description of transition risks would seem to be applicable across a broad range of industries: 'the financial risks which could result from the process of adjustment towards a lower-carbon economy. Changes in policy, technology and physical risks could prompt a reassessment of the value of a large range of assets as costs and opportunities become apparent'.

A6. The United Nations Framework Convention on Climate Change Conference of the Parties in Paris in November/December 2015 agreed to strengthen the global response to the threat of climate change…including by 'holding the increase in global average temperature to well below 2 degrees Celsius above pre-industrial

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[4] Comment letter on 2015 Agenda Consultation from Sarasin & Partners http://www.ifrs.org/Current-Projects/IASB-Projects/IASB-agenda-consultation/2015-agenda-consultation/Pages/Comment-letters.aspx

[5] Speech by Mark Carney at Lloyd's of London 29 September 2015 http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech844.pdf

levels…'[6]. Some estimate that a consequence of achieving such a goal could be that a large proportion of oil, gas and coal reserves will be 'stranded', that is unburnable without expensive carbon capture technology. These stranded carbon assets were given as an example of transition risks by Mr Carney.

A7. Information about the impact, or potential future impact, on an entity's financial performance and financial position of risks, including climate change risks, may be material information that requires inclusion in an entity's financial report.

A8. Some IFRS Standards, specifically IAS 36 *Impairment of Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, set out IFRS requirements that could be relevant to some of the risks posed by climate change.

A9. Other IFRS Standards include several general requirements to include information in an IFRS financial report in circumstances where there are not specific requirements. IAS 1 *Presentation of Financial Statements* sets out a number of such general requirements.

A10. The guidance on materiality, including the draft Four-step Approach, could assist management in identifying when information about the impact, or potential impact of climate change on an entity's financial performance and financial position should be included in an entity's financial report.

A11. To assess how the Four-step Approach could assist in applying materiality in preparing an IFRS financial report and identifying how it could be improved, we describe a scenario to focus discussion.

Scenario – impact of climate change on an airline

A12. Entity A operates a low-cost airline across the region in which it is located. It operates a fleet of aircraft from hubs in two major capital cities.

A13. There is prospect of tougher climate legislation, taxes, etc. on fuel and on emissions to achieve the 2 degrees target in the UN agreement:

[6] United Nations Framework Convention on Climate Change Paris Agreement http://unfccc.int/meetings/paris_nov_2015/items/9445.php

a. An already proposed curb on emissions – through a cap and trade scheme in which only a limited quantity of credits are available in order to promote reductions of greenhouse gasses by airlines;

b. Already proposed tax increases to reduce the use of fossil fuels; and

c. Other future legislative action remains a possibility.

A14. Please consider:

a. What information users need about the risks posed to Entity A by future climate change; and

b. How management might assess whether that information is material to Entity A's financial report.

A15. In your discussions please consider both the direct and indirect consequences of climate change.