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Dear Kevin

Proposed Improvements to International Accounting Standards

The Auditing Practices Board (APB) is the audit standard setting body for the United Kingdom and the Republic of Ireland and welcomes the opportunity to comment on the proposals published by the IASB in May 2002, some of which are pertinent to the APB's own work programme. This letter follows the helpful discussions with you on 1 October 2002.

Two exposure drafts address matters of particular interest to the APB; IAS 1 'Presentation of financial statements' and IAS 8 'Accounting policies, changes in accounting estimates and errors'. The matters of most concern relate to:

In IAS 1:

- A need for further guidance on materiality;
- Disclosure of the level of precision in the financial statements; and
- The override provisions.

In IAS 8:

- The correction of errors.

Our concerns about these and other matters are explained below.

IAS 1 'Presentation of financial statements'

(1) Guidance on materiality

The concept of materiality is fundamental to both the preparation and the audit of financial statements. To help mitigate aggressive earnings management, the APB believes that further guidance for preparers of financial statements, as well as for auditors, is needed.

The International Auditing and Assurance Standards Board (IAASB) has a task force that is working on an update of International Standard on Auditing 320 on materiality. The APB would encourage IASB to liaise with that task force with the ultimate aim of developing consistent guidance for preparers and auditors of financial statements.

In particular, guidance is needed to emphasise the importance of considering the nature of an item when judging whether it would influence the economic decisions of a user of the financial statements. In some circumstances even very small amounts might be material. Issues that could usefully be explored in additional guidance include:

- the legality, sensitivity, normality and potential consequences of the event or transaction (e.g. whether it affects compliance with regulations or with loan covenants; or increases rewards for management);
- the effect on the evaluation of trends and key financial indicators (e.g. whether it masks a failure to meet expectations of the entity in relation to the level of earnings or earnings per share, or changes a loss into a profit or vice versa);
- the identity of the parties involved (e.g. whether external parties to transactions are related to members of the entity's management);
- the particular financial statement items affected and the perceived significance of the item to users of the financial statements;
- whether the item is capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate (see also our comments below on the disclosure of accounting policies and measurement uncertainties).

Disclosure of the level of precision in the financial statements

Paragraph 44(e) of the exposure draft of IAS I (revised) requires disclosure of *'the level of precision used in the presentation of the amounts in the financial statements'*. It is not clear exactly what is intended by this. The term 'precision' is normally used to describe a level of accuracy and, in some respects, is akin to the term 'materiality'. Disclosure of the levels of materiality used by management when, for example, making judgments and preparing accounting estimates affecting the information presented in the financial statements could be very helpful to a user of those financial statements, although clearly there would need to be further guidance for preparers. Care would be needed in making the disclosure as in practice different levels of materiality will be appropriate to different items in the financial statements depending on the nature of the items and the circumstances.

However, the text in paragraph 46 of the exposure draft appears to suggest that the term 'precision' is actually intended to mean the level of rounding used in presenting the financial statements (i.e. whether the amounts are rounded and presented in thousands or millions etc.). If this is the case, then the term 'precision' may be the wrong one to use and 'order of magnitude and rounding' may be more suitable.

The definition of materiality

When considering the materiality of an item it is important to have regard to both its size and nature. In relation to this, there is an inconsistency in the way materiality is defined in IAS I (in both the extant standard and the exposure draft) and in the 'Framework for the preparation and presentation of financial statements' (the Framework) see the attachment to this letter. The APB supports the definition in IAS 1, which refers to both size and nature, rather than the definition in the Framework, which does not refer to the nature of an item.

If it is impracticable for IASB to amend the Framework at this time, it would help if the definition in IAS I could be broadened to define materiality generally and not just in the context of aggregation and disclosure of items in the financial statements. This would help to ensure that, when considering issues such as misstatements and uncertainties related to measurement as well as disclosure, due regard is given to the nature of an item as well as its size.

The application of accounting standards to immaterial items

The rubric at the start of each exposure draft states that *'International Accounting Standards are not intended to apply to immaterial items (see paragraph 12 of the Preface).'* However, the revised Preface published in May 2002 does not include a reference to materiality. Consequently, it is not clear whether, in future, the exemption from applying IASs to immaterial items will continue. We note that paragraph 27 of the proposed revision of IAS 1 states that 'Applying the concept of materiality means that the specific *disclosure* requirements of International Financial Reporting Standards and Interpretations of those Standards need not be met if the resulting information is not material', but this does not provide a complete exemption from applying Standards and Interpretations to immaterial items (e.g. measurement requirements would still apply).

The APB would be concerned if the intention is to remove the exemption. It would be reasonable to encourage the application of accounting standards to immaterial items but unreasonable to mandate such compliance where, for example, the costs may outweigh the benefits. Also, consideration should be given to how compliance with a principle that accounting standards should apply to immaterial items could be enforced. Auditors only qualify their opinion on the financial statements on grounds of non compliance when they consider the effect to be material such as to influence the economic decisions of users taken on the basis of the financial statements.

Further guidance on materiality (see above) could help prevent 'immateriality' being used as an improper excuse not to apply accounting standards.

(2) Fair presentation

Link of presumption to override provisions

It would be helpful if there was a clearer link between the wording of the presumption stated in the last sentence of paragraph 10:

> 'The application of International Financial Reporting Standards and Interpretations of those Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.'

and paragraphs 13 and 14, to make it clear that there may be extremely rare circumstances where the presumption should be overridden.

Additional disclosure and national prohibitions against override

If the objective of harmonisation of accounting requirements is to be achieved, the revised IAS 1 should not provide for alternative treatments according to the regulatory framework of the country in which the financial statements are issued. Whilst it may be necessary in some circumstances to supplement the application of accounting standards with additional disclosures to achieve a fair presentation, it should be made clear that in the extremely rare circumstances where accounting standards need to be overridden to achieve a fair presentation, application of the override cannot be avoided by making additional disclosures. Accordingly, the words 'if the relevant regulatory framework requires or otherwise does not prohibit such a departure' at the end of paragraph 13 should be deleted and paragraph 15 should be deleted entirely.

The last sentence in paragraph 14 of the extant IAS 1 should be included in the revised IAS: 'The existence of conflicting national requirements is not, in itself, sufficient to justify a departure in financial statements prepared using International Accounting Standards.'

The wording in paragraph 12 of the extant IAS 1 'Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.' should also be included in the revised IAS.

Use of the term 'true and fair'

For the avoidance of doubt it would be helpful if the revised Standard made clear, possibly by way of a footnote to paragraph 10, that the term 'show a true and fair view' is an acceptable alternative to 'present fairly'. The equivalence of these terms is recognised in paragraph 46[1] of the Framework.

(3) Disclosure of accounting policies and measurement uncertainty

The APB welcomes, in principle, the IASB's proposals set out in paragraphs 108 to 115 of the exposure draft of IAS 1 regarding the disclosure of information concerning management's judgements in choosing accounting policies and the disclosure of key measurement assumptions. The disclosure of information concerning such judgements applied by management, including the sensitivity to the underlying assumptions and the range of possible outcomes is essential for a full understanding of the financial statements.

The following suggestions may help to improve the quality of the information that management decides to disclose.

Requiring a linkage with the entity's business plans

The Framework states that 'To be reliable information must represent faithfully the transactions and other events that it either purports to represent or could reasonably be expected to represent' (paragraph 33). Historical information is concerned with what has happened and so whether it faithfully represents its subject matter is a question that can be approached on the basis of evidence about past transactions and events. However, measurement assumptions are about the future and guidance would be helpful as to what process management should use to develop and support their assertions.

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[1] Paragraph 46 of the Framework states: 'Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.'

In our view there should be a requirement for the information provided in meeting the requirements ‘of paragraphs 108 and 110 of the exposure draft of IAS 1 to be supported by the entity’s strategies, plans and risk analysis and to be consistent with planned courses of action published elsewhere by the entity.

Subsequent validation

Paragraph 112(d) suggests that an explanation of changes made to past assumptions may be one of the disclosures made. The APB would like to see such disclosures elevated in status to being a requirement of the Standard (i.e. set out in bold text). Management should be held to account for the judgements that they have made and changes thereto.

Broadening the scope of paragraph 110

It is not entirely clear to us why paragraph 110 restricts itself to measurement uncertainty relating to:

- assets and liabilities; and
- the next financial year.

The APB recommend that these restrictions be removed from the Standard because:

- there may be measurement uncertainty with respect to items of income and expenditure that are not reflected in either assets or liabilities. For example there may be uncertainty over the ultimate measurement of revenue relating to a project. All the billed revenue may have been received and other possible amounts of revenue may be so uncertain in their receipt that they do not meet the recognition criteria of a receivable. Under these circumstances any measurement uncertainty would not relate to the carrying amount of an asset or a liability and therefore would not fall to be disclosed under the requirements of paragraph 110;
- many uncertainties extend well beyond the next financial year and it seems arbitrary to select such a threshold. If our comments on making the linkage with the entity’s business plans were to be accepted then the APB consider that a better threshold would be the period covered by such plans

(4) Going concern

Paragraph 19 states ‘In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date.’ The period of twelve months from the balance sheet date will, for some entities, extend only a relatively short period past the date the financial statements are actually issued and, in consequence, be of little value to a user of those financial statements. The APB believes that a longer period for consideration would be more appropriate.

The Statement of Auditing Standards on going concern (SAS 130) that we issued in 1994, and with which auditors in the UK and Republic of Ireland are required to comply, requires that:

> ‘If the period to which the directors have paid particular attention in assessing going concern is less than one year from the <u>date of approval of the financial statements</u>, and

the directors have not disclosed that fact, the auditors should do so within the section of their report setting out the basis of their opinion .....'

There are relatively few instances where auditors make such disclosure. This suggests that management generally are able to consider a period of at least one year from the date of approval of the financial statements. The APB recommend that IASB refers in paragraph 19 of IAS 1 to twelve months from the date of approval rather than twelve months from the balance sheet date.

(5) Responsibility for the financial statements

It is essential to make clear who has responsibility for the preparation and presentation of the financial statements. The wording in paragraph 6 of the extant IAS 1 should be included in the revised IAS: 'The board of directors and/or other governing body of an enterprise is responsible for the preparation and presentation of its financial statements.' There are so many user misconceptions about who has ultimate responsibility for the preparation of financial statements that any means of clarification is welcome.

IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'

Definition of 'errors'

It is not helpful for the term 'errors' by definition to be related solely to prior periods (paragraphs 3 and 34). It would be more appropriate to use a term such as 'prior period errors'. This will help avoid possible confusion during the preparation, and audit, of financial statements when considering errors relating to the current period, as well as any errors relating to prior periods.

Correction of errors

Paragraph A13 of the appendix to the exposure draft states that 'The Board also proposes to eliminate the distinction between fundamental errors and other material errors. Under this amendment all material errors would be treated in the same manner as a fundamental error ...'. However, it is not clear from the wording of paragraph 32 that the requirement to correct errors retrospectively only applies to material errors - the requirement could be read to apply to all errors (as we have indicated above, it is not clear whether the current exemption from applying IASs to immaterial items will continue in the future).

The APB disagrees with the proposal in paragraphs 32 and 33 that all errors shall be accounted for retrospectively. The APB supports the current distinction between fundamental and other material errors and believe that only fundamental errors need be accounted for retrospectively.

We are concerned that, regardless of the proposed disclosure requirements, the revision would:

- result in a frequency of restatement of prior year figures that would be unsettling to users of financial statements and may cause a lowering in general of confidence in financial reporting; and
- may be open to abuse and provide opportunities for aggressive earnings management.

It is not uncommon to find errors relating to a prior period, although we believe the occurrence of 'fundamental' errors to be relatively rare. In consequence, particularly in the absence of any materiality consideration, comparative amounts would be restated relatively frequently. This may have a significant impact on the perceptions of users of the financial statements.

Opportunities for aggressive earnings management may be seen in the ability to make errors in one period and then correct them in a subsequent period, by restating the comparative amounts or opening balance of retained earnings, without affecting the reported earnings of the subsequent period.

Accounting estimates

The APB is generally supportive of the improvements that arc proposed to IAS 8. However, with regard to changes in accounting estimates the requirements should be more robust and aligned with the requirements for changes in accounting policy. Our particular concern is to remove what might be perceived as considerable flexibility in the improved IAS for management to freely revise estimates from one period to another with little justification other than a desire to present a more favourable impression. This may be done, for example, where the measurement basis or method applied produces a range of acceptable amounts and management move the position within the range from which the amount included in the financial statements is taken. Significant changes in estimates may result without there being any apparent change in the measurement basis.

Paragraph 9 of the proposed IAS establishes as a bold letter standard:

> 'A change in an accounting policy shall be made only if it:
>
> (a) is required by a Standard or an interpretation of a Standard; or
>
> (b) results in a more relevant and reliable presentation in the financial statements of the effects of transactions or other events on the entity's financial position, financial performance or cash flows.'

There is no equivalent bold letter principle governing when changes in accounting estimates should be made. Paragraph 25 of the proposed IAS is not a bold letter standard but sets out the circumstances when it is acceptable for an estimate to be revised. The APB recommends that this paragraph be redrafted as a bold letter principle along the following lines:

> 'An accounting estimate shall only be revised as a result of information or experience that was not available at the time that the previous estimate was made or on the basis of subsequent developments, such that a better estimate is produced.'

Similarly, the APB recommends that paragraph 29 of the proposed IAS have added to it a requirement for the reason for the change in estimate to be disclosed. This would align paragraph 29 with paragraph 23 dealing with disclosures regarding changes to accounting policies. Such disclosure would also better enable readers of the financial statements to understand the issues affecting management's judgments and to consider the quality of governance.

It should be made clear that management revise an estimate when they are aware it is appropriate to do so.

Undue cost or effort

A number of the proposed revised standards permit exemption on the basis of 'undue cost or effort'. This term is open to wide interpretation and potential abuse. The IASB should provide further guidance to clarify the meaning of the term and give examples of when it may and may not be an appropriate reason not to apply a standard.

If you consider there is a need for further explanation of any of our comments please contact the APB's Technical Director, Jon Grant.

Yours sincerely

J Grant

pp. WID Plaistowe
Chairman

Attachment

IASB definitions of materiality

In IAS 1, materiality is addressed in the context of considering whether items should be presented separately in the financial statements or aggregated. Paragraph 26 of the exposure draft states:

> ‘In this context, information is material if its non-disclosure could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the <u>size and nature</u> of the item judged in the particular circumstances of its omission. In deciding whether an item or an aggregate of items is material, the nature and the size of the item are evaluated together. Depending on the circumstances, either the nature or the size of the item could be the determining factor. ....'

In the Framework, materiality is addressed in the context of being a factor affecting the relevance of information to the decision making needs of users. The focus is on size with the nature of the information treated as a separate factor to materiality. Paragraph 30 states:

> ‘Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.’