

International Financial Reporting Standards



Materiality

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or the IFRS Foundation.

Agenda

- Materiality
 - What is it?
 - Why are we looking at it?
- General materiality principles
 - Authoritative sources
 - Financial reporting
- Application problems
- IASB response

Purpose of this presentation

- We wish to obtain your views on:
 - our analysis; and
 - our proposals for how the IASB should respond.

- We will invite you to express opinions and ask questions and the end of each main section.

Materiality: what is it?

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Characteristics of materiality

- Abstract concept
- Describes a decision to include or not—acts as a filter
- Requires judgement
- Based on the “substance” of something
- Applies in different contexts

There seems to be broad agreement on what the general concept means.

Materiality—another way to think about it



Example—a job application

- You are making a decision about hiring someone:
 - you probably don't need to know the applicant's life story.
 - but you want enough information for you to be able to assess their character.
 - you also want enough information to allow you to assess whether they have the specific skills for the job.
- If you make a bad hiring decision and then discover information about the applicant that, if known at the time, would have led you to not offer the job, that information is *material* in that particular situation:
 - the information might not have been disclosed at all; or
 - the information might be in hundreds of pages of information and therefore obscured.

General principles—a preparer perspective

- To assess whether you should tell someone something, or bring it to their attention, you need to know:
 - what types of decision are likely to be made;
 - how the information is used to assess a particular matter, relevant to that decision; and
 - whether information is likely affect an assessment of a matter and whether that matter is important enough to affect the decision being made.
- You also need to know what you are entitled to assume about the decision maker – skill level, experience etc.
- The challenge/difficulty is applying this to financial reports.

Materiality: why are we looking at it?

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Disclosure problem

Too much
irrelevant
information

Not enough
relevant
information

Poor
communication

What role does
materiality play?



Possible problems applying materiality

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Applying materiality to financial reports

- Lack of understanding of the general concept.
- Unclear how to apply, ie what do I need to tell investors?
- Some Standards imply that judgement is not required (or welcome).

Behaviour

- Asymmetric caution – fear of getting it wrong dominates.
- Time and resource constraints.

Understanding the user

- The level of detail wanted by users varies.
- Preparers may not understand how users use information – there is an expectation gap.
- Unclear who users are.

General materiality principles: authoritative sources

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- Discussions with representatives of IOSCO and the IAASB in setting the scope of our work.
- An analysis of how the concept is applied in different jurisdictions and different contexts:
 - we requested help from national and regional standard-setters.
- A review of academic papers, requirements by regulators, industry papers and case law.
- Discussions with academics and practitioners.

Paragraph QC11 of the *Conceptual Framework*, (2010):

“Information is material if omitting it could influence decisions that users 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 or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report. Consequently the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.”

- Legal:
 - case law/securities law;
 - final arbitrator (case law); and
 - continued associations /cross-pollination.
- IFRS (IAS 1, IAS 8)
- Auditing:
 - outline of characteristics (ISA 320).
- Other corporate reporting
- Common use

Other jurisdictions

- Most definitions (local, the IAASB etc) are similar to the IFRS *Conceptual Framework* definition:
 - most are judgement-based;
 - entity-specific; and
 - decisions about providing economic resources.
- Other sources (eg case law) link the materiality decision to different impacts, for example:
 - fraud on the market;
 - effect on the share price; and
 - voting decisions.
- A few local requirements provide quantitative thresholds for example, 3% or more of total assets.

Can accounting and legal definitions co-exist?

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For example, the US has a lot of authoritative sources:

- the Securities Act of 1933 has many references to *material* but does not define it.
- the US courts have developed their definition to interpret the Securities Act 1933.
- *Materiality* is defined/described in CON 8 (it is the same wording as the IFRS *Conceptual Framework*):
 - the CON 8 and US court definitions are qualitatively the same, although there is one threshold difference; and
 - the CON 8 (and, before that, CON 2) definitions have never been considered by the US Courts.

- Do we need a definition?
 - US definition has been evolved by the courts.
 - many jurisdictions have operated without a definition.
- Observations:
 - some jurisdictions are likely to find it helpful if the IASB has a definition. Some might find it unhelpful.
 - the definition will need to work across jurisdictions (ie not conflict with established precedent).
 - the definitions used in Standards and the IFRS *Conceptual Framework* should be consistent.

General materiality principles: financial reporting

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Materiality applied to financial reports

Generic characteristics of materiality	Characteristics of materiality in IFRS
Include or not	A decision to include or omit financial information.
Judgement	Using professional judgement.
Substance	On the basis of whether its omission could influence <u>decisions</u> that <u>users</u> make (relevance).
Context	In the <u>context</u> of an entity's financial reports (entity-specific).

- Materiality is context-specific, for example:
 - an entity (entity-specific);
 - the financial report:
 - management commentary;
 - primary financial statements; and
 - notes.
 - the circumstances in which the information will be used:
 - equity investment decision;
 - lending decision; and
 - voting decision.
- The question is not whether an individual piece of information is *material* by itself, but in the light of its context (as a whole).

The user

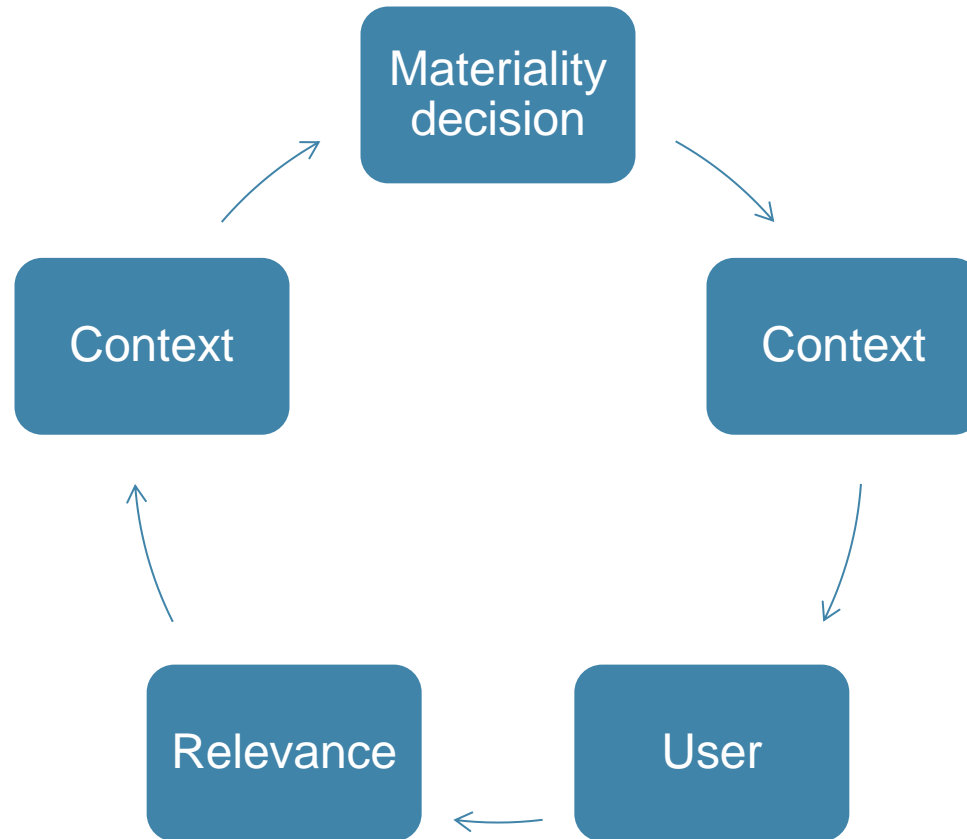
- Hypothetical decision maker.
- You need to know some characteristics about the decision-maker:
 - what expectations you can have of the decision maker; and
 - what level of supporting data is reasonably expected by the decision-maker.
- The IFRS *Conceptual Framework* describes the user as:
 - existing and potential investors, lenders and other creditors;
 - having reasonable knowledge of business and economic activities;
 - That review and analyse the information diligently; and
 - That may need to seek the aid of an adviser.

- Some case law
 - NZ Heath J in *R v Moses* “between one who is completely risk averse and someone who is prepared to take a high level of risk”, who can understand the language of the “narrative sections of both an investment statement and a prospectus” has a general understanding of the technical nature of words such as “debenture” and “roll-over”. They would seek assistance from a financial advisor and understand the advice.

Relevance (ie the decision)

- Materiality is the entity-specific aspect of relevance.
- Relevance relates to understanding a particular type of activity or matter:
 - ie what information is relevant to a particular type of decision?
 - for example, fair value is relevant information for assessing liquid marketable securities.
- Materiality involves assessing whether that matter is sufficiently important to an understanding of an entity:
 - ie is that information relevant to those making decisions about an entity?
 - for example, does this entity have any liquid marketable securities?

Materiality decision



- Do you have any comments on the general materiality principles and the way that we have described them in this presentation?

Application problems

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We have heard—more materiality guidance?

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More

- The concept is unclear and not well understood.
- Guidance is needed to help entities know how to apply the concept in financial reports.

No more

- The concept is clear and generally well understood.
- Problems applying the concept are behavioural – additional guidance will not help.
- Concerns will conflict with a jurisdiction's standards/law.

Drafting in IFRS

- Language used in IFRS is overly prescriptive, overriding the judgement inherent in materiality:
 - an entity shall disclose.
 - at a minimum.
- Different terms are used to indicate that a materiality judgement is needed, for example:
 - significant;
 - sufficiently material; and
 - most important.

- What information is relevant to a particular topic is not clearly described or is at too high a level.
- Lack of clear disclosure objectives – what information is relevant to a particular decision:
 - for example, accounting policies, purpose of the primary financial statements.
- A materiality decision is made ‘easier’ by clearer links between:
 - the information; and
 - how it affects the assessment of a matter (the objective).

- If it is not clear what information is needed to be able to assess a matter it is difficult to make materiality assessments:
 - the more you disclose the more likely it is that the material information will be there somewhere.
- The IASB should determine what information is normally necessary for assessing particular matters.

Qualitative and quantitative assessments

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- The fact that a figure is large (a quantitative focus) does not make it material:
 - a quantitative amount is just one ‘quality’;
 - materiality is a qualitative assessment; and
 - stated materiality thresholds (£/\$1 billion in some cases) create the wrong perception—that nothing under a billion matters.
- Brightlines and prescribed percentage thresholds:
 - discourage judgements;
 - cause boilerplate disclosures; and
 - create a false sense that meeting brightline tests is sufficient.
- Brightlines can also be created by lists of disclosure requirements.



Other factors

- What is material differs between entities and periods.
- Subjective/entity-specific/professional judgement:
 - will be shaped by you and your context.
- It can mean different things, in different contexts and jurisdictions – it has to!
- Some information is more important than others, which creates a perception that there are different levels of materiality.

“...if it doesn't really matter, don't bother with it.”
(Hicks, 1964)

- In your opinion, what are the problems applying materiality?

IASB response

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- Discussion with the IFRS Advisory Council.
- Discussion with the World Standard-setters.
- Additional consultation with the IAASB and IOSCO.
- Development of a full Staff Paper, elaborating on the matters raised in this presentation, for IASB discussion.

- **Educational material:**
 - the general principles of materiality:
 - common characteristics/themes;
 - not prescriptive;
 - judgement based (qualitative);
 - applicable across jurisdictions;
 - compatible across contexts (legal, regulatory etc) – eg IAASB;
 - behavioural factors; and
 - things entities should consider when applying materiality (non-exhaustive list).
 - application (to IFRS) examples:
 - why some information has a lower “threshold”; and
 - why the IASB will not establish bright lines.
 - develop an outreach plan.

Possible approaches

- **Guidance for the IASB:**
 - clearer working principles for drafting standards, for example:
 - clearer explanations required as to what is relevant to a decision in each Standard.
 - review existing and new disclosure requirements [started].
- **Definition of material in IFRSs:**
 - align definitions within the *Conceptual Framework* and Standards; and
 - ensure that the definition does not conflict with the broader use of the term.

- Do you agree with the possible approaches?