

## STAFF PAPER

September 2014

## IASB Meeting

Project	Disclosure Initiative		
Paper topic	Materiality—accounting policy disclosures		
CONTACT(S)	Amy Bannister	<a href="mailto:abannister@ifrs.org">abannister@ifrs.org</a>	+44 (0)20 7246 6947
	Kristy Robinson	<a href="mailto:krobinson@ifrs.org">krobinson@ifrs.org</a>	+44 (0)20 7246 6933

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction

1. Throughout the development of the Disclosure Initiative, the IASB has heard concerns about accounting policies disclosures in financial statements. At its [March meeting](#), the IASB tentatively decided to undertake work to consider whether additional guidance for accounting policy disclosures could be developed. That guidance would assist entities determine what information about accounting policies should be disclosed in their financial statements.
2. This paper:
  - (a) sets out the motivation for this paper (paragraphs 3–7);
  - (b) highlights the requirements in IAS 1 *Presentation of Financial Statements* for accounting policy disclosures (paragraphs 8–11);
  - (c) sets out the problem we have heard with accounting policy disclosures and what constituents have suggested should be disclosed for accounting policies (paragraphs 12–18);
  - (d) provides an analysis about accounting policy information in financial statements, including staff conclusions (paragraphs 19–36); and
  - (e) discusses whether the IASB should start a narrow focus project or include a discussion on accounting policy information as part of its Principles of Disclosure project (paragraphs 45–0).

## Motivation

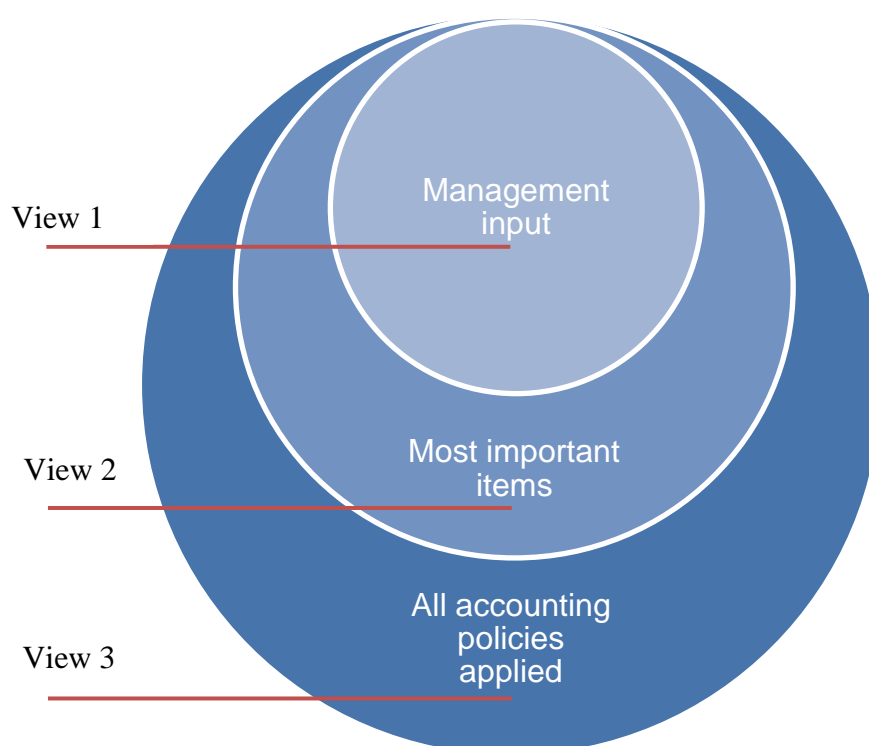
3. Accounting policy disclosures are often identified as examples of poor disclosure practice. We have heard that this is because they often include a recitation of accounting literature making it difficult to:
  - (a) relate the accounting policy to the entity and its activities; and
  - (b) assess which accounting policy disclosures are most important.
4. This message was highlighted in the [Financial Reporting Disclosure Discussion Forum Feedback Statement](#). This message has also been raised in reports by others, including the:
  - (a) [CFA Institute report on Financial Reporting Disclosures](#); and
  - (b) [FRC Lab's report on accounting policies and integration of related financial information](#).
5. We have also heard that guidance about accounting policies in IAS 1 *Presentation of Financial Statements* is not helpful. This is because it is not clear what makes an accounting policy 'significant' and it is therefore difficult to assess which accounting policies should be disclosed.
6. Constituents have indicated that a project on accounting policies is needed in order to improve disclosures. This was a strong message received in feedback to the *Disclosure Initiative: Amendments to IAS 1* Exposure Draft.
7. We think that poor accounting policy disclosures are symptomatic of problems in applying materiality. Specifically, we think entities have difficulty in answering the following questions:
  - (a) what makes a disclosure about an accounting policy useful ie what is the objective of the disclosure?; and
  - (b) what can be assumed about the users of accounting policy disclosures?

## IAS 1 requirements

8. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines accounting policies as:
  - the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements
9. Paragraph 10 of IAS 1 states that a complete set of financial statements comprises, among other things, a summary of significant accounting policies. Paragraph 117 of IAS 1 requires an entity to disclose in a summary of significant accounting policies:
  - (a) the measurement basis (or bases) used in preparing the financial statements; and
  - (b) the other accounting policies used that are relevant to an understanding of the financial statements.
10. Paragraphs 118–121 of IAS 1 sets out some additional guidance to meet that requirement. The relevant text from IAS 1 is set out in Appendix A to this paper.
11. We have already taken some steps to start addressing two problems in IAS 1. In its *Disclosure Initiative: Amendments to IAS 1* Exposure Draft, the IASB has proposed that paragraph 120 be deleted because it implies, by using the income taxes and foreign currency examples, that all accounting policies need to be disclosed. The Exposure Draft also proposes amendments intended to clarify that accounting policies need not to be disclosed in one note, but could instead be disclosed as part of other notes alongside disclosures to which that accounting policy relates. However, while we think these changes will clarify some aspects of IAS 1 we think additional steps are required to help preparers and users of financial statements reach a shared understanding of how best to disclose accounting policies in a meaningful way.

## What we have heard

12. One of the most commonly expressed concerns is that accounting policy statements in Financial Reports are summaries of the IFRS requirements. Many have suggested that the explanations of the accounting policy disclosures should be tailored to reflect the entity and explain how accounting guidance has been applied in the context of the entity's activities.
13. More fundamentally, we have heard different views about what factors make an accounting policy 'significant'. The views can be depicted as follows:



### ***View 1 – accounting policies that involve management input***

14. Some have suggested that accounting policy information should only be disclosed for the following circumstances:
- (a) there is a choice to the entity in application (for example, measuring investment property at fair value or cost), including selection in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when there is no IFRS that specifically applies to a transaction, other event or condition (paragraph 10 of IAS 8);

- (b) the entity has changed accounting policies during the period (for example, changing from one choice to another, or applying a new Standard); and
- (c) applying the policy requires judgement;<sup>1</sup> a high accrual component is a helpful indication that the reporting entity will have needed to use estimates, such as recognition of provisions, revenue recognition for long-dated performance obligations and depreciation estimates for long-lived assets; the use of level-three fair values or the presence of uncertain liabilities potentially suggests judgement about the measurement (and sometimes existence) of assets or liabilities; the existence of investments about which the control assessment has major implications for the financial statements could indicate that the entity has needed to apply judgement.

## ***View 2 – ‘most important’ accounting policies***

- 15. Some have suggested that accounting policies are significant and should be disclosed if they relate to the transactions, events and circumstances that are most important, or unique, to the entity’s business, regardless of whether management has any discretion. Examples include revenue (which some suggest is always significant because it is fundamental to many entity’s activities) and foreign exchange where, for example, a large number of an entity’s subsidiaries have functional currencies different to that of the consolidated group.
- 16. The [FRC Lab report \*Accounting policies and integration of related financial information\*](#) identifies Views 1 and 2 as being held by some institutional investors. The report does note that institutional investors would still like access to the information about an entity’s remaining accounting policies on its website.

---

<sup>1</sup> The FRC Lab report noted that ‘...many investors do not differentiate between accounting policy, judgement and estimate disclosures, in the way that accounting standards distinguish them. Investors often describe estimates when asked which accounting policies they refer to most...’

### ***View 3 – all accounting policies applied***

17. Some users of financial statements have suggested that they want information about all of the accounting policies applied by the entity in producing its financial statements. We think they want this information because:
- (a) not all users of financial statements are familiar with accounting literature; and
  - (b) some users of financial statements consider that the financial statements should be a stand-alone document.
18. The [FRC Lab report \*Accounting policies and integration of related financial information\*](#) identifies View 3 as being held by some retail investors.

### **Staff analysis**

19. In this section we explore:
- (a) what makes a disclosure about an accounting policy useful, ie what is the objective of accounting policy disclosures (paragraphs 21–30); and
  - (b) what we can assume about the accounting knowledge of users of accounting policy disclosures? (paragraphs 31–36).
20. Our conclusions are set out in paragraphs 37–44.

### ***What is the objective of accounting policy disclosures?***

21. We think that an entity needs to know the objective of accounting policy disclosures (ie what makes an accounting policy useful) to be able to decide what accounting policy information to disclose in its financial statements.
22. As stated in the *Conceptual Framework*, useful financial information must be relevant and must faithfully represent what it purports to represent.<sup>2</sup>
23. Paragraph QC6 of the *Conceptual Framework* describes relevant information as ‘capable of making a difference in the decisions made by users’. The *Conceptual Framework* also states that one of the characteristics of faithful representation is

---

<sup>2</sup> Paragraph QC12 of the *Conceptual Framework*

that information should be complete. Paragraph QC13 of the *Conceptual Framework* expands on the notion of completeness and states that ‘a complete depiction includes all information **necessary** for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations’ [emphasis added].

24. We think that some information about accounting policies is **necessary** for users to understand relevant information about an entity’s transactions, events and circumstances. For example, disclosing that an entity has chosen to measure its investment properties at fair value is necessary for users to understand the relevant information, ie the amount recognised for investment properties. Without this information there is no other way for a user of financial statements to know how the entity measured the investment property and therefore understand what the reported amount communicates. Hence information in financial statements will not be ‘complete’ and therefore not a faithful representation without information about some accounting policies.
25. In addition, some accounting policies could be necessary to understand the business and how the business operates, for example, disclosures about an entity’s revenue recognition policy. This may be because they are pervasive, or integral, to how the entity’s financial position or financial performance is reported.
26. However, we also think other information about accounting policies may also warrant being included in financial statements. This is because disclosing other information about accounting policies may **enhance the understandability** of financial statements. For example, an entity disclosing that it has been required to measure its inventory at the lower of cost and net realisable value may make the recognised amount for inventory more understandable. In addition, disclosing all accounting policies in one place (ie, in the financial statements), could address concerns about accessibility of accounting policy information and serve as a reminder even for users of financial statements with strong accounting knowledge.
27. We think that both ideas of completeness (ie information that is necessary) and enhanced understandability are covered in paragraph 117(b) of IAS 1 which requires that accounting policies that are ‘relevant to an understanding of the financial statements’ are disclosed.

28. In addition, we think that accounting policy information should only be provided for **material** transactions, events or circumstances. This is because it is only the material transactions, events or circumstances that are capable of making a difference in users of financial statements decisions. For example, a user of financial statements will not find accounting policy information for IAS 41 *Agriculture* relevant to an understanding of the financial statements if the entity has immaterial, or no, agriculture transactions, events or circumstances.
29. Lastly, we agree with constituents who suggest that accounting policy disclosures should be entity-specific. The disclosures about accounting policies should be tailored to the entity and explain how the accounting guidance has been applied in the context of the entity's activities. This makes the accounting policy disclosures more useful, for example, an entity should disclose its revenue recognition policy for its revenue streams, as opposed to the generic revenue recognition requirements.
30. Consequently, we think that the objective of accounting policy disclosures is to provide necessary context to, and enhance the understandability of, an entity's material transactions, events and circumstances.

### ***Accounting knowledge of users of financial statements***

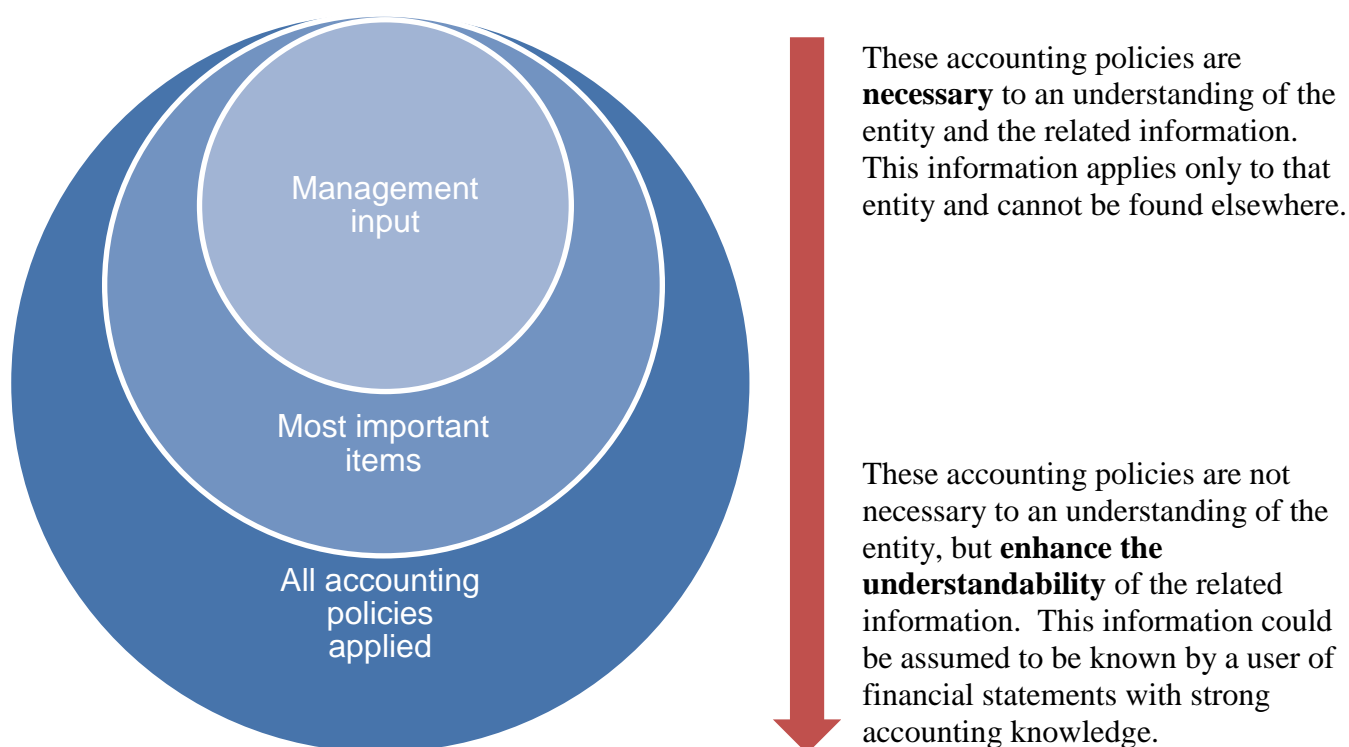
31. Some users of financial statements think that financial statements should provide information about all the accounting policies of the entity because disclosure of all accounting policies makes the financial statements more understandable (View 3). Others think that there should be certain circumstances for when accounting policy information should be disclosed (Views 1 and 2).
32. The proposed objective in paragraph 30 above could indicate that all accounting policies for material transactions, events and circumstances should be disclosed. However, we think that an entity also needs to consider the accounting (and IFRS) knowledge of the users of its financial statements when making decisions about what accounting policy information to disclose. This is because an entity needs to make a judgement about what accounting knowledge users of its financial statements may already have or are willing and able to obtain from a source outside of the financial statements.



33. Arguably, if information about accounting policies that could be obtained from another source was not disclosed (ie, the accounting policy information identified as **enhancing the understandability**) the financial statements would still be complete, because the disclosure of those policies in the financial statements would not be **necessary** to a user’s understanding.
34. Paragraph QC32 of the *Conceptual Framework* indicates that users of financial statements have a reasonable knowledge of business and economic activities. It also states that they review and analyse the information diligently and that at times they may need to seek the aid of an adviser to understand information about complex economic phenomena.
35. We could interpret this paragraph in two ways:
- (a) Users of financial statements should have accounting knowledge and do not need to rely on the financial statements to understand how IFRS has been applied to produce many aspects of the financial statements. In addition, if users of financial statements do not know the accounting policy requirements then they could seek the aid of an adviser or are able to obtain information about how IFRS has been applied from another source eg the IASB’s website. This could result in the conclusion that financial statements should only disclose accounting policies for material transactions, events and circumstances that are necessary to an understanding of the relevant information and that cannot be obtained elsewhere.
  - (b) Users of financial statements are not assumed to have accounting knowledge and should not be assumed to know accounting policy requirements. The *Conceptual Framework* is clear that users of financial statements are only assumed to have **business and economic knowledge** and does not state they should be assumed to have accounting knowledge. The *Conceptual Framework* states that users of financial statements should seek the aid of an adviser for **complex economic phenomena**. This could result in the conclusion that financial statements should provide information about all accounting policies for material transactions, events and circumstances (ie, those

that are both necessary to an understanding and enhance the understandability of the relevant information).

36. Applying this to the different Views of what information about accounting policies should be disclosed, we consider that:



### **Conclusion**

37. We think that objective of accounting policy disclosures is to provide necessary context to, and enhance the understandability of, an entity’s material transactions, events and circumstances. In addition, we think that accounting policy disclosures should be more entity-specific and explain how the accounting guidance has been applied in the context of the entity’s activities.
38. Although IAS 1 does provide some guidance on the circumstances that could make an accounting policy significant, practice suggests that this guidance is not clear to all. We think that the factors included in IAS 1 for assessing whether an accounting policy should be disclosed should be based on the level of management input, or judgement, into the classification, recognition and measurement decisions, ie if there a choice in accounting policy, a change in accounting policy or significant judgement in applying the accounting policy (View 1).

39. We think that judgement is needed by entities to determine both:
- (a) what policies are necessary to an understanding of the material transactions, events and circumstances and should therefore be disclosed in the financial statements; and
  - (b) what policies enhance the understandability of the material transactions, events and circumstances and could be disclosed in the financial statements.
40. An entity will need to consider the needs of users of their financial statements when considering which accounting policies to disclose. Those needs could change over time, for example, if an entity has just adopted IFRS, or a Standard, versus several years after adoption. Before IFRS became widely adopted, an analyst reviewing the financial reports of a wide range of, for example, Telecommunication Companies, would likely have needed the entity to explain its local GAAP requirements.
41. Consequently, an entity could consider that all accounting policies for material transactions, events and circumstances should be disclosed in their financial statements. We do not think that IAS 1 should prohibit the disclosure of all accounting policies for material transactions, events and circumstances, because they could enhance the understandability of some entities' financial statements, therefore meeting the objective of accounting policy disclosures.
42. However, we are mindful that one of the criticisms of accounting policy disclosures in financial statements is 'overload' and 'clutter'.
43. Consequently, we think that the accounting policies which an entity determines are necessary for an understanding of its financial statements should be made more prominent. We think these include all of those described in View 1 as having an element of management input. We think it may also include some or all of its 'most important' accounting policies (View 2), although an entity may need to use judgement to determine which policies this may include.
44. We think that guidance should be provided in IAS 1 to promote the prominence of the necessary accounting policies. We think some examples of prominence could include:

- (a) including a summary of the necessary accounting policies in one note;
- (b) including a summary in the front of the notes indicating which notes in the financial statements contain the necessary accounting policies; or
- (c) disclosing the accounting policy information provided to enhance the understandability of the financial statements in one place, for example, in an appendix towards the back of the financial statements.

### Question 1

Does the IASB agree with the staff analysis above, in particular:

- a) the objective of accounting policy disclosures is to provide necessary context to, and enhance the understandability of, an entity's material transactions, events and circumstances;
- b) financial statements could include information about entity-specific accounting policies for all material transactions, events and circumstances; and
- c) entities should use judgement to determine which accounting policies should be more prominent in the financial statements, but at a minimum the accounting policy information where there is a choice, change or significant judgement should be made more prominent in the financial statements?

### Next steps

45. We think that the IASB could either:
- (a) propose narrow-focus amendments that address these matters now ie develop an Exposure Draft; or
  - (b) include accounting policies as a topic in the Principles of Disclosure project.

46. We think that the IASB should include a discussion about accounting policies in the forthcoming Principles of Disclosure Discussion Paper because:
- (a) there is overlap with other topics in that project, for example, the objective of the notes and grouping of information;
  - (b) practice regarding disclosure of accounting policies is evolving without the IASB’s intervention. We have heard of entities amending their accounting policy disclosures to be more useful to users; and
  - (c) different views have been expressed about what makes an accounting policy significant which would benefit from further discussion as part of the Discussion Paper

**Question 2**

Does the IASB agree to include a discussion about accounting policy disclosures in the Principles of Disclosure Discussion Paper?

## Appendix A—significant accounting policy requirements in IAS 1

### Disclosure of accounting policies

- 117 **An entity shall disclose in the summary of significant accounting policies:**
- (a) **the measurement basis (or bases) used in preparing the financial statements, and**
  - (b) **the other accounting policies used that are relevant to an understanding of the financial statements.**
- 118 It is important for an entity to inform users of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) because the basis on which an entity prepares the financial statements significantly affects users' analysis. When an entity uses more than one measurement basis in the financial statements, for example when particular classes of assets are revalued, it is sufficient to provide an indication of the categories of assets and liabilities to which each measurement basis is applied.
- 119 In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position. Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives allowed in IFRSs. An example is disclosure of whether an entity applies the fair value or cost model to its investment property (see IAS 40 *Investment Property*). Some IFRSs specifically require disclosure of particular accounting policies, including choices made by management between different policies they allow. For example, IAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment.
- 120 Each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. For example, users would expect an entity subject to income taxes to disclose its accounting policies for income taxes, including those applicable to deferred tax liabilities and assets. When an entity has significant foreign operations or transactions in foreign currencies, users would expect disclosure of accounting policies for the recognition of foreign exchange gains and losses.
- 121 An accounting policy may be significant because of the nature of the entity's operations even if amounts for current and prior periods are not material. It is also appropriate to disclose each significant accounting policy that is not specifically required by IFRSs but the entity selects and applies in accordance with IAS 8.
- 122 **An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.**
- 123 In the process of applying the entity's accounting policies, management makes various judgements, apart from those involving estimations, that can significantly affect the amounts it recognises in the financial statements. For example, management makes judgements in determining:
- (a) [deleted]
  - (b) when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities; and
  - (c) whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue.
- 124 Some of the disclosures made in accordance with paragraph 122 are required by other IFRSs. For example, IFRS 12 *Disclosure of Interests in Other Entities* requires an entity to disclose the judgements it has made in determining whether it controls another entity. IAS 40 *Investment Property* requires disclosure of the criteria developed by the entity to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business, when classification of the property is difficult.