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Disclosure Initiative

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Agenda

- Background and overview
- Materiality
- Accounting policy disclosures

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Background

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Agenda Consultation 2011

- "A disclosure framework is needed to ensure that information disclosed is more relevant to investors and to reduce the burden on preparers"

Discussion Forum

- Obtain views from those in the financial reporting process
- Survey also undertaken

Feedback Statement

- Summarises what we have heard
- Highlights potential next steps for the IASB

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An overview

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Disclosure Initiative

Implementation		Research			Ongoing activities
Amendments to IAS 1	Reconciliation of liabilities from financing activities	Materiality	Principles of Disclosure	Review of existing Standards	Digital reporting New EDs

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Materiality

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Agenda

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

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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 during the break-out sessions

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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.

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Materiality: why are we looking at it?

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We have heard

Disclosure problem

Too much irrelevant information

Not enough relevant information

Poor communication

What role does materiality play?

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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.

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General materiality principles:

authoritative sources

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Our research

- 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.

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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."

Other sources

- 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.

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Definition in IFRS/international GAAP

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- 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.

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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 decisions that users make (relevance).
Context	In the context of an entity's financial reports (entity-specific).

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Context

- 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 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.

The user

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- 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.

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Relevance (ie the decision)

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- 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?

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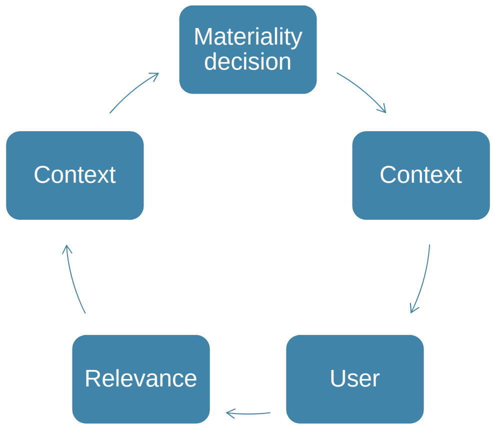
Materiality decision



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Application problems

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We have heard—more materiality guidance?

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More	No more
• The concept is unclear and not well understood. • Guidance is needed to help entities know how to apply the concept in financial reports.	• 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

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- 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.

IFRS disclosures—relevance

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- 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).

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IFRS disclosures—relevance continued

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- 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.

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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

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- 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.

Simple Description

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

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IASB response

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Planned steps

- 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.

Possible approaches

- **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.

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Questions for WSS

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Questions for WSS

- Do you have any comments on the general materiality principles and the way that we have described them in this presentation?
- In your opinion, what are the problems applying materiality?
- Do you agree with the possible approaches?

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Accounting policy disclosures

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Agenda

- Background and motivation
- IAS 1 requirements
- What we have heard
- Analysis
  - What is the objective of disclosing accounting policies?
  - Is the disclosure of accounting policies for all material transactions, events and circumstances necessary?
  - Conclusions
- Next steps
- Questions for WSS

Background and motivation

- Accounting policies are invariably mentioned when poor disclosure is discussed
- We think the criticisms of how accounting policies are disclosed are symptomatic of problems with applying materiality:
  - What makes an accounting policy relevant?
  - What can we assume about the intended audience?
- We think this is a good area to demonstrate how important it is to set clear objectives in a Standard, and potentially foster improved disclosure

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Requirements in IAS 1
Presentation of Financial Statements

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IAS 1 requirements

- A complete set of financial statements includes a summary of significant accounting policies
- An entity is required to disclose:

  The measurement basis (or bases) used in preparing the financial statements; and
  The other accounting policies used that are relevant to an understanding of the financial statements

  IAS 1.117

- Includes additional guidance for accounting policy disclosures
  – *Amendments to IAS 1* Exposure Draft proposed to delete some potentially unhelpful examples

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What we have heard

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What we have heard

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- Many have told us that accounting policy disclosures should be improved:
  - Repetition of accounting literature
    - Not entity-specific
    - Boilerplate
  - Accounting policy disclosures are “cluttered” making it difficult to identify what policy information is important
  - It is not clear what makes an accounting policy “significant”
- Message heard in many places, including at the Disclosure Forum, in feedback to IAS 1 amendments and reports by others

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What makes an accounting policy significant?

- Some suggest that accounting policies are significant if they have a high level of management input:
  - A choice of accounting policy (eg investment property at fair value or cost)
  - A change in accounting policy
  - The policy requires a considerable use of judgement, eg if there is is a high accrual component
    - eg control, estimated life, residual value

What makes an accounting policy significant?

- Some think that accounting policies are significant if they relate to the items that are more important, or unique, to the entity's business—regardless of whether management has any discretion
    - eg, revenue, foreign exchange

What makes an accounting policy significant?

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- Some would like information about **all** the accounting policies for an entity:
  - Not all users are familiar with accounting literature
  - Financial statements should be a stand-alone document

The FRC Lab report* on accounting policy disclosures identified this view as being held by retail investors and the other views by institutional investors. The report noted that institutional investors were supportive of additional policy information being available on the company's website.

* https://frc.org.uk/Our-Work/Codes-Standards/Our-Work-Codes-Standards-Financial-Reporting-Lab/Published-project-reports.aspx

A suggested framework

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Analysis

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Analysis

- What is the objective of accounting policy disclosures?
- Is the disclosure of accounting policies for all material transactions, events and circumstances necessary?
  - Faithful representation
  - The user of accounting policy disclosures
  - Accounting knowledge of users

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Objective

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- Accounting policies disclosures should be:
  - – entity-specific (tailored to entity)
  - – only provided for material transactions, events and circumstances
  - – eg, no agricultural business, no IAS 41 *Agriculture* disclosures
- Accounting policy disclosures enhance the understandability of the related information
  - – eg, an investor would probably use accounting policy information when making decisions to provide context to the relevant information

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Faithful representation

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Faithful representation (QC32):
A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations

Without information about all accounting policies for material transaction, events and circumstances, users of financial statements may not be able to understand the reported information. The financial statements may not be complete and therefore not a faithful representation.

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The user of accounting policy disclosures

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Necessary to an understanding of the entity and the related information. This information applies only to that entity and cannot be found elsewhere.

Less necessary to an understanding of the entity and the related information *as the accounting knowledge of the user increases*.

This information *could* be assumed to be known by a knowledgeable user of financial statements.

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Knowledge of users

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Users of financial statements (QC32):

have a reasonable knowledge of business and economic activities

review and analyse the information diligently

may need to seek the aid of an adviser

The information should be known – users should have accounting knowledge

If they do not they should seek the aid of an adviser

Financial statements need not provide information about all accounting policies for material transactions, events and circumstances. Doing so could mask the important policies

Not assumed to have accounting knowledge, only business and economic

Should only seek the aid of an adviser for complex economic phenomena

Financial statements should provide information about all accounting policies for all material transactions, events and circumstances. Users with less accounting knowledge need this information to understand the financial statements

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Staff conclusions

- The objective of accounting policy disclosures is to help the user understand the classification, recognition and measurement criteria applied by the entity
- Although IAS 1 provides some guidance on the factors that could make an accounting policy potentially significant, practice suggests that the guidance is not clear to all
- Those factors should be on the basis of management input/judgement into classification, recognition and measurement decisions.
  - Ie, choice, change, estimates (eg, useful life, value, timing, etc).

Staff conclusions

- Judgement is needed to determine what policies are necessary to an understanding and should be included in the financial statements
- Entities will need to consider the needs of their users
  - This could change over time
- Guidance should be provided to promote prominence of the "more significant" accounting policies in the financial statements
- The IASB could consider requiring (more) disclosure about judgements required by a Standard and how the Standard was applied

Staff conclusions

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- We should not prevent an entity from disclosing accounting policies for **all** material transactions, events and circumstances—but they should be entity-specific.
- Regardless, the “more significant” accounting policies should be prominent in the financial statements, and distinguishable from the “less significant” accounting policies.

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Examples of prominence

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Include a summary of “more significant” accounting policies in one note

or

Include a summary in the front of the notes section indicating which notes in the financial statements contain the “more significant” accounting policies

Disclose the “less significant” accounting policy information, for example, in an appendix towards the back of the financial report

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Next steps

Next steps

- IASB could:
  - start a narrow focus amendments project to amend accounting policy disclosure requirements – view to publish an Exposure Draft; or
  - include this discussion as part of the Principles of Disclosure Discussion Paper
- Staff recommendation—include in the Discussion Paper
  - There are strong links with the analysis of accounting policy disclosures and areas in the Principles of Disclosure project – objective of the notes, grouping of information, etc.
  - Practice is evolving without our intervention

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Questions for WSS

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Questions for WSS

- What factors do you consider make an accounting policy significant?
- Do you agree with, or have any comments on, the staff analysis and conclusions for accounting policy disclosures?
- Do you agree that changing the accounting policy disclosure requirements would be better considered in the Principles of Disclosure project?


individual comments
questions
comment
expressions of individual views
feedback
questions
feedback
comments
questions or comments
expressions of individual views
comments
questions or individual comments
expressions and viewpoints

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