

STAFF PAPER

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Project	Disclosure Initiative: Materiality		
Paper topic	Stewardship		
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Purpose of this paper

1. This paper considers comments received on the Exposure Draft and should be read together with Agenda Paper 11 *Materiality - Cover paper*. It asks the Board to consider, in the light of the comments received, whether the final *Practice Statement* should include guidance on stewardship considerations in the application of materiality.

Guidance proposed in the Exposure Draft

2. Paragraph 22 of the Exposure Draft identified:
 - Some examples of ways in which management can identify whether information is or is not useful to the primary users include
 - (a) considering information about users' expectations, including how they think the entity should be managed (ie stewardship) gathered through discussions with users or from information that is publicly available [emphasis added].
3. Paragraph 30 of the Exposure Draft noted that the primary objective of financial statements is to 'provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in

making economic decisions'. It also noted that financial statements 'show the results of the management's stewardship of the resources entrusted to it'.

4. Finally, paragraph 39 of the Exposure Draft provided examples of materiality considerations when aggregating information. It highlighted that when an entity aggregates information it should take care not to remove information that allows users to assess management's stewardship of the entity:

... an entity may have a small net foreign exchange difference as a result of transactions in foreign currencies. That net difference might have arisen from a large number of small exchange gains on a broad base of recurring transactions and a substantial loss that resulted from one speculative forward foreign exchange transaction. IAS 21 *The Effects of Changes in Foreign Exchange Rates* specifies only that the amount of exchange differences is disclosed. When making judgements about materiality, the entity should assess whether the loss should be reported separately from the other exchange differences. The fact that a large loss was incurred relative to the other transactions, and that the loss was from speculative activity, suggests that aggregating these exchange differences would result in a loss of material information. *In this scenario, information that could influence users' opinions of management's stewardship would be lost through aggregation* [emphasis added] (paragraph 39(b) of the Exposure Draft).

Summary of the feedback

5. We received a small number of comments on the interaction between stewardship and materiality. The Hong Kong Association of Banks (CL27) stated that paragraph 22(a) of the Exposure Draft on the interaction of materiality and stewardship is unclear. They asked for further explanation.
6. Similarly, the European Financial Reporting Advisory Group (EFRAG) identified, areas they considered should be the 'primary focus for guidance on applying

materiality’, and stated that one of these areas was ‘how the consideration of stewardship affects materiality’ (CL92).

7. EFRAG also stated that:

The objective of financial statements refers to both the usefulness of the information for users’ decision-making and to the assessment of stewardship.

Although some references to the stewardship objective are included in the draft Practice Statement, the guidance and illustrative examples contained in the draft Practice Statement essentially refer to the first objective.

EFRAG therefore believes it is unclear which of the objectives should prevail or whether the entity should always consider the lowest common denominator that achieves both objectives (CL92).

8. Federation of European Accountants (FEE) welcomed the Board’s proposals with respect to stewardship in the Conceptual Framework and supported the references to stewardship in the final *Practice Statement*. However, they asked the Board to clarify or revise the guidance in paragraph 22(a) of the final *Practice Statement* as they ‘do not believe that management should consider how users “think the entity should be managed (i.e. stewardship)” when assessing materiality’ (CL31).

9. Another respondent, the Heads of the Treasury Accounting and Reporting Advisory Committee (HoTARAC), asked for more examples:

... covering some high level issues in the Practice Statement for which no illustrative examples are provided, such as management’s stewardship, uncertainties and contingencies, and interim financial reporting. Scenarios to be addressed could include probity and related party transactions as they relate to management’s stewardship (CL8).

Staff analysis and recommendation

Stewardship as a qualitative materiality factor

10. The *Conceptual Framework for Financial Reporting* states that:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

In order to meet this objective an entity needs to provide information about both the prospects for future cash flows and information needed to assess management's stewardship of the entity's resources.

11. The Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting (Conceptual Framework ED)*¹ published in May 2015, proposed to clarify that stewardship is included within the objective of financial reporting. The Board decided in May 2016 to include the following paragraph in the final *Conceptual Framework*²:

Information about how efficiently and effectively the entity's management has discharged its responsibilities to use the entity's resources helps users assess management's stewardship of those resources. Such information is also useful for predicting how efficiently and effectively management will use the entity's resources in future periods and, hence, is useful for assessing the entity's prospects for future net cash inflows.

12. The Board also decided to clarify in the *Conceptual Framework* the link between the objective of financial reporting and stewardship by explaining resource allocation decisions as:

- (a) 'decisions to buy, sell or hold equity and debt instruments;

¹ <http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Exposure-Draft-and-Comment-letters.aspx>

Paragraph 1.22 of the Exposure Draft of the *Conceptual Framework*.

- (b) decisions to provide or settle loans and other forms of credit; and
 - (c) decisions needed to exercise rights while holding investments, such as rights to vote on or otherwise influence management's actions³.
13. In the light of the Board deciding to clarify the link between stewardship and the objective of financial reporting we propose that the Board includes in the final *Practice Statement* guidance that reminds an entity that information about how efficiently and effectively management discharges their responsibilities can be material.
14. Last month, the Board discussed a four-step 'Materiality Process' for applying materiality judgements to an entity's financial statements⁴. The second step of the process proposes that when an entity is assessing the materiality of an item of information, it considers whether its primary users could reasonably be expected to be influenced by that information when making economic decisions on the basis of the financial statements. This Step 2 includes a number of qualitative factors to consider when making this assessment.
15. We recommend that the Board includes an additional qualitative factor in Step 2 of the Materiality Process, linked to stewardship. In considering this factor, an entity would consider whether the item of information being assessed provides information needed to assess management's stewardship of the entity.

Objective of financial statements

16. EFRAG commented that they understood that the objective of financial statements refers to both the usefulness of the information for users' decision-making and to the assessment of stewardship. They also said that the Exposure Draft was unclear about which of these two aspects (users' decision-making and assessment of stewardship) should prevail.

³ Decision taken in May 2016. Summary of tentative decisions in the Conceptual Framework Project, published October 2016 <http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/October%202016/Summary-of-tentative-decisions-October-2016.pdf>

⁴ See Agenda Paper 11D *The Materiality Process* from October 2016. <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2016/October/AP11D-DI.pdf>

17. We think that information that helps users assess management’s stewardship of the entity’s resources is part of the information needed by users to make resource allocation decisions. Consequently we think both of the aspects identified by EFRAG are relevant and it would be inconsistent with the Board’s tentative decisions for the forthcoming revisions to the *Conceptual Framework* to identify one as prevailing over the other.

Question for the Board

Question 1

Do you agree that the Board should include in the list of qualitative factors in Step 2 of the Materiality Process, to be included in the final *Practice Statement*, a qualitative factor in relation to stewardship?