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Purpose of this paper

1. This paper considers the comments received on the Exposure Draft and should be read together with Agenda Paper 11A *Materiality - Cover paper*. It asks the Board to reconsider, in the light of the comments received, the guidance on identifying primary users, their information needs and their expectations for the purposes of applying materiality when preparing IFRS financial statements.

Guidance proposed in the Exposure Draft

2. The definition of materiality quoted in the Exposure Draft refers to the decisions made by the *users* of general purpose financial statements:

Information is material if omitting it or misstating it could influence *decisions that users make* on the basis of financial information about a specific reporting entity [emphasis added] (paragraph 7 of the Exposure Draft, paragraph QC11 of the Conceptual Framework for Financial Reporting (the *Conceptual Framework*)).

3. As acknowledged in footnote 5 of the Exposure Draft, paragraph 2.11 of the Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* (*Conceptual Framework* ED), proposes to modify the definition of materiality by

including the word ‘primary’ before the word ‘users’. For the purpose of this paper, whenever we refer to ‘users’ we intend ‘primary users’.

4. According to the Exposure Draft the identification of the entity’s primary users and their information needs is part of the materiality assessment. The Exposure Draft provided guidance on the characteristics of the primary users of financial statements (paragraphs 15–19) and described the decisions made by the primary users and their information needs (paragraphs 20–23)¹.
5. In particular, the Exposure Draft:
 - (a) suggested entities consider, as part of the materiality assessment, ‘how the information will be used by the primary users of the financial statements’ (paragraph 12);
 - (b) quoted the guidance from the *Conceptual Framework* on the identification of primary users of general purpose financial statements (paragraphs 13 and 15);
 - (c) reiterated that, although entities are ‘entitled to assume that the primary users have a reasonable knowledge of the business and economic activities, they cannot assume that the primary users are financial reporting experts’ (paragraph 16);
 - (d) acknowledged an entity may have several different types (classes) of primary users, and, ‘if an entity has many classes of primary users, the financial statements should present and disclose information so as to meet the common information needs of a broad range of those classes’ (paragraph 17);
 - (e) stated that information ‘would usually be expected to be material if it is relevant to either a range of primary users across different classes or to a significant class of primary users’ (paragraph 19);
 - (f) stated that when an entity considers what information should be provided in the financial statements, ‘the requirements in IFRS should provide the basis for that assessment’ (paragraph 21), because, in

¹ The referenced paragraphs are included in full in the Appendix.

developing IFRS Standards, the Board already ‘seeks to identify the information that is expected to meet the needs of a broad range of primary users’ (paragraph 21); however ‘it is not sufficient to apply the presentation and disclosure requirements in a Standard mechanically, without considering the entity’s specific circumstances, *whether the entity’s primary users have any special needs* and whether the information provided meets or exceeds the needs of an entity’s primary users’ [emphasis added] (paragraph 21); and

- (g) provided examples of ways an entity can identify whether information is or is not useful to the primary users, based on the assessment of those primary users’ *expectations* (paragraph 22).

Summary of the feedback

- 6. The guidance provided in the Exposure Draft prompted comments on the following issues:
 - (a) the link between materiality and primary users’ needs and expectations;
 - (b) the identification of different classes of primary users;
 - (c) the identification of the ‘special needs’ of primary users; and
 - (d) the use of the term ‘expectation’ throughout the Exposure Draft.

The link between materiality and primary users’ needs and expectations

- 7. Several respondents agreed that identifying primary users’ needs would help entities to identify whether information is material. In particular, the CFA Society of the UK (CFA UK) CL72² welcomed ‘the framing of the guidance by a consideration of the primary users of financial statements and their information needs’ and supported ‘the philosophy underpinning the [Exposure Draft], which requires genuine thought from preparers about the users of their financial statements’; while the UK Financial Reporting Council (FRC) CL10, as well as

² The reference CLxx refers to the ID number assigned to the comment letter. The comment letters can be found at <http://www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Materiality/Exposure-Draft-October-2015/Pages/Comment-letter.aspx>

the European Banking Authority (EBA) CL57, considered the identification of financial statements' primary users and their needs as first steps in applying the concept of materiality to financial statements.

The identification of different classes of primary users

8. However some respondents thought the differentiation of information needs between *classes* of primary users and the requirement to meet the common information needs of a *broad range* of primary users is potentially inconsistent.
9. In particular, according to the Australia and New Zealand Banking Group Limited (ANZ) CL47:

... the last sentence of paragraph 17 [of the Exposure Draft] implies that information need not be disclosed unless it meets the common information needs of a broad range of primary users whereas paragraph 19 suggests information needs to be disclosed if it is relevant to a significant class of primary users (ie implies it does not have to be common to multiple classes).

10. These respondents suggested rewording paragraphs 17–19 of the Exposure Draft focusing on the information needs of classes of primary users considered *as a whole*, having reference to the classes of primary users contemplated in the *Conceptual Framework* (existing and potential investors, lenders and other creditors):

We suggest paragraphs 17, 18 and 19 [of the Exposure Draft] be clarified to distinguish between the information needs of specific individual primary users (within a class) and the information needs of classes of primary users (as a whole) having reference to the four *classes* of primary users contemplated by the *Conceptual Framework* for Financial Reporting being existing investors, potential investors, lenders and other creditors (ANZ CL47).

The identification of the ‘special needs’ of primary users

11. Different views were expressed by respondents regarding the concept of ‘primary users’ special needs’ outlined in paragraph 21 of the Exposure Draft:
- (a) some respondents were concerned that ‘this concept (...) is not consistent with the current definition of general purpose financial statements (...) which focuses on the “common” information needs of a wide range of users’ (KPMG CL69, a similar concern was raised also by Singapore Accounting Standards Council (Singapore ASC) CL93);
 - (b) other respondents questioned whether the focus on ‘primary users’ special needs’ might lead to an inappropriate reduction, or omission, of information when the users of financial statements include (for instance) only the parent entity and tax authority (a common situation for private entities in some jurisdictions) (PricewaterhouseCoopers (PwC) CL81 and South African Institute of Chartered Accountants (SAICA) CL54); PwC went further suggesting that ‘the requirements of the standards determine what should be disclosed rather than user expectations’ (CL81);
 - (c) one respondent agreed that ‘the identification of the primary users of financial statements and the specific needs of those users is a necessary prerequisite to an appropriate materiality assessment’ (International Organization of Securities Commissions (IOSCO) CL95), and another respondent considered the identification of any ‘primary users’ special needs’ as a ‘fundamental point’ (Basel Committee on Banking Supervision (BCBS) CL82).

The use of the term ‘expectation’ throughout the Exposure Draft

12. Some respondents were concerned that the guidance which focused on the need to identify primary users’ expectations would demand preparers to have ‘insight into users’ minds’ (eg Hong Kong Association of Banks (HKAB) CL27), a process that might be ‘burdensome, time consuming and potentially giving rise to delays in the issuance of financial statements’ (Federation of European Accountants (FEE) CL31).

Feedback from ASAF members

13. We presented our initial analysis of comments received on this subject at the July 2016 ASAF meeting, asking for members' advice and comments on the identification of primary users, their information needs and expectations. Some ASAF members raised concerns similar to those of some respondents:
- (a) they questioned whether the identification of different classes of primary users would create tension with the current definition of general purpose financial statements, which focuses on the common information needs of a wide range of users;
 - (b) they agreed the requirements in IFRS Standards should be the starting point in determining what information should be disclosed in financial statements; the materiality assessment should then involve quantitative *and* qualitative assessment on the primary users' needs;
 - (c) they were concerned that the emphasis the Exposure Draft placed on the concept of primary users' *special needs* and *expectations* might suggest a focus only on the entity's existing users, narrowing the information provided in the financial statements;
 - (d) one member suggested clarifying that primary users includes *potential* investors, *potential* lenders and *potential* other creditors, and the consequence this has for the information that should be included in the financial statements.

Staff analysis and recommendation

14. We considered the feedback received from those who commented on the Exposure Draft together with the advice from the ASAF members. Our analysis is organised as follows:
- (a) clarifications relating to 'primary users' of general purpose financial statements;

- (b) the reference made to the concepts of ‘primary users’ special needs’ and the references to ‘classes’ or ‘subsets’ of primary users throughout the Exposure Draft;
- (c) the use of the term ‘expectations’ of primary users throughout the Exposure Draft; and
- (d) the concept of ‘meeting the maximum amount of common information needs of an entity’s primary users’.

Clarifications relating to ‘primary users’

- 15. Some respondents commented on the importance of referring to ‘primary’ users of the financial statements. Paragraph 2.11 of the *Conceptual Framework* ED proposes to modify the definition of materiality by including the word ‘primary’ before the word ‘users’³. We agree that it is important to make clear that when applying materiality it is the impact on primary users that is relevant to the materiality assessment.
- 16. We recommend that the final IFRS Practice Statement: Application of Materiality to Financial Statements (the final *Practice Statement*) should also refer to ‘primary users’ throughout the final *Practice Statement*. This would address respondents’ concerns and align the language in the final *Practice Statement* with that in the *Conceptual Framework*.
- 17. The primary users of the entity’s financial statements are defined in paragraph OB5 of the *Conceptual Framework* as ‘existing and potential investors, lenders and other creditors’. We agree with the suggestion made in the ASAF meeting that the final *Practice Statement* makes clear that this means an entity’s existing and potential investors, existing and potential lenders and existing and potential other creditors.
- 18. We believe this would:
 - (a) address respondents’ concerns about the inappropriate focus on specific *existing* users that some entities applying IFRS Standards may have; and

³ As the Exposure Draft acknowledged, in footnote 5.

(b) make clear that an entity cannot narrow the information provided in the financial statements by focusing only on its existing users' information needs.

19. We therefore recommend that the Board should emphasise in the final *Practice Statement* that the 'primary users' of the entity's IFRS financial statements include *potential* investors, *potential* lenders and *potential* other creditors. This would be consistent with the definition of primary users in paragraph OB5 of the *Conceptual Framework*). This would respond to the concerns raised that an entity might inappropriately narrow the information provided in the financial statements by focusing only its existing users' information needs.

Reference to 'primary users' special needs' and 'classes' or 'subsets' of primary users

20. A common concern raised by respondents to the Exposure Draft and ASAF members was that the Exposure Draft went further than the *Conceptual Framework* in requiring an entity to identify 'subsets' or 'classes' of primary users and their corresponding 'special information needs'.

21. On the basis of the feedback we received, we recommend that the Board should remove any reference to the 'special needs' of primary users and references to 'subsets' or 'classes' of primary users from the final *Practice Statement*. Our main reasons are:

- (a) requiring an entity to identify users' special needs is inconsistent with the *Conceptual Framework* definition of general purpose financial statements, which focuses on the 'common information needs'⁴ of existing and potential investors, lenders and other creditors;
- (b) the assessment of any primary users' special needs would require an entity to specifically identify how the information provided through the financial statements is used by their users; moreover it would be an impractical exercise when related to the entity's *potential* investors, lenders and other creditors;

⁴ See paragraph OB8 of the *Conceptual Framework*.

- (c) the wording currently used in paragraphs 17–19 of the Exposure Draft may suggest the existence of a hierarchy among primary users’ ‘subsets’ or ‘classes’; this might lead entities to consider an item of information as being material on the basis of the relative significance of the particular ‘subset’ or ‘class’ of primary users who need that information (eg a class with a larger number of users) rather than on the relevance (ie capacity to influence the primary users’ decisions) of the information itself⁵; and
- (d) the concept of ‘subsets’ or ‘classes’ of primary users is not used in IFRS Standards except for in paragraph OB8 of the *Conceptual Framework*. This paragraph refers to ‘subsets’ of primary users stating that ‘focusing on common information needs does not prevent the reporting entity from including *additional* information that is most useful to a particular *subset* of primary users’ [emphasis added]. However in the Basis for Conclusions of the *Conceptual Framework* the Board refers to ‘the primary users group’ instead of emphasising the existence of ‘subsets’ or ‘classes’ of primary users (see paragraphs BC1.14–BC1.17 of the *Conceptual Framework*). General purpose financial reports are intended to provide common information to primary users and cannot accommodate every request for information (see paragraph BC1.18 of the *Conceptual Framework*).

Use of the term ‘expectations’ of primary users

22. The term ‘expectations of primary users’ has been used differently in the Exposure Draft compared with the *Conceptual Framework*.
23. The *Conceptual Framework* uses the term to refer to primary users’ expectations about returns, and how these are dependent on the primary users’ assessment of

⁵ See paragraph BC1.18 of the *Conceptual Framework* about the Board’s reasoning on hierarchy among users: ‘Some (...) recommended that the Board should establish a hierarchy of primary users because investors, lenders and other creditors have different information needs. However, the Board observed that individual users may have information needs and desires that are different from, and possibly conflict with, those of other users with the same type of interest in the reporting entity. General purpose financial reports are intended to provide common information to users and cannot accommodate every request for information’.

the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity⁶.

24. The Exposure Draft uses the term ‘expectations’ to:
 - (a) distinguish between subsets of primary users (paragraph 17); and
 - (b) describe how management could identify whether information is or is not useful to primary users (paragraph 22).
25. We think these differences in uses of the term ‘expectations’ are unhelpful, and have led to some respondents to the Exposure Draft concluding that the preparer needs to have insight into the users’ minds. We do not think entities should be expected to have that type of insight.
26. We therefore recommend the Board should not use the term ‘expectations’ of primary users in the final *Practice Statement* except when using it in the same way as it is used in the *Conceptual Framework*.

Meeting the maximum amount of common information needs of an entity’s primary users

27. Based on the feedback received from respondents to the Exposure Draft and ASAF members, together with the considerations presented above, we believe the guidance on ‘Users of the financial statements and their decisions’, paragraph 13–23 of the Exposure Draft, should be revised to emphasise the concept of meeting ‘the maximum amount of *common* information needs’ of an entity’s primary users’.
28. The appropriate assessment would require an entity to identify information needs that are *common* within each category of primary users, being existing and potential investors, existing and potential lenders and existing and potential other creditors as defined in the *Conceptual Framework*. The ‘maximum amount of *common* information needs’ would be the sum of the common information needs of these three categories.

⁶ During its redeliberations of the comments on the *Conceptual Framework* ED, the Board has tentatively decided to add that primary users’ expectations of returns additionally depend on the primary users’ assessment of management’s stewardship of resources.

29. We think that meeting the maximum amount of *common* information needs of an entity’s primary users does not involve the identification of information needs that are necessarily *simultaneously* common to *all categories* of an entity’s primary users (ie shared between *all* existing and potential investors, lenders and other creditors). If an entity focuses only on information needs that are common to *all* categories of its primary users, it might exclude information needs that are relevant to a particular category of its primary users (eg existing and potential investors) if those information needs are not shared by other categories of primary users (eg existing and potential lenders or other creditors).
30. Moreover, an entity does not need to consider information needs that address unique, individual or niche request, because they are not *common* information needs.
31. Finally, an entity is required to complete the assessment considering its specific characteristics, that is, identifying those information needs that each category of its primary users share, considering the type, nature, industry, etc. of that specific entity.
32. Hence, an entity is required to identify the ‘entity-specific *information needs*’ of its primary users rather than its ‘entity-specific *primary users*’ (as mentioned before, the primary users an entity should refer to are those defined in the *Conceptual Framework*—being existing and potential investors, existing and potential lenders and existing and potential other creditors).
33. We recommend that the Board revises the guidance on ‘Users of the financial statements and their decisions’ (paragraph 13–23 of the Exposure Draft) in the final *Practice Statement* to reflect the concept of ‘meeting the maximum amount of common information needs of an entity’s primary users’ (as described in paragraphs 28–32). This will move the guidance away from a ‘primary users’ special needs’ assessment to an ‘entity-specific’ assessment of the primary users’ information needs.

Questions for the Board

Question 1—clarification relating to ‘primary users’

Do you agree that the Board should:

(a) refer to ‘primary users’ (as defined by the *Conceptual Framework*) throughout the final *Practice Statement*; and

(b) emphasise in the final *Practice Statement* that the ‘primary users’ of the entity’s IFRS financial statements include *potential* investors, *potential* lenders and *potential* other creditors?

Question 2—reference to ‘primary users’ special needs’ and ‘classes’ or ‘subsets’ of primary users

Do you agree that the Board should remove the references to the ‘special needs’ of primary users and references to ‘subsets’ or ‘classes’ of primary users from the final *Practice Statements*?

Question 3—use of the term ‘expectations’ of primary users

Do you agree that the Board should not use the term ‘expectations’ of primary users in the final *Practice Statement* except when using it in the same way as it is used in the *Conceptual Framework*?

Question 4—meeting the maximum amount of common information needs of an entity’s primary users

Do you agree that the Board should revise the guidance provided on ‘users of the financial statements and their decisions’ in the final *Practice Statement* to reflect the concept of ‘meeting the maximum amount of common information needs of an entity’s primary users’?

Appendix

Extract from the Exposure Draft

Judgement

- 12 When assessing whether information is material to the financial statements, management applies judgement to decide whether information could reasonably be expected to influence decisions that the users make on the basis of those financial statements. When applying such judgement, management should consider both the entity's specific circumstances and how the information will be used by users of the financial statements. An entity's circumstances change over time and so materiality is reassessed in each reporting period in the light of the entity's circumstances during that period. This assessment should include comparing the current year information with comparative information for prior periods to assess changes in the entity's activities or circumstances during the period.

Users of the financial statements and their decisions

- 13 The definition of materiality refers to decisions made by the *users* of general purpose financial reports. The *Conceptual Framework* identifies the primary users of general purpose financial reports as follows and states that they are the users to whom those reports are directed:
- OB5 Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.
- OB10 Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.
- 14 Having identified the primary users of the entity's general purpose financial statements and other general purpose financial reports, management should consider the characteristics of those users, including their likely interests and what types of decisions they are making. This will then enable management to identify the information that the primary users could reasonably expect to receive and that could reasonably be expected to influence their decisions.

Characteristics of the primary users of financial statements

- 15 The *Conceptual Framework* sets out basic attributes of the primary users of the financial statements:
- QC32 Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.
- 16 Although management is entitled to assume that the primary users have a reasonable knowledge of business and economic activities, they cannot assume that the primary users are financial reporting experts. Furthermore, management should focus on typical

and rational users, rather than a single, atypical user that is behaving unreasonably or irrationally.

- 17 An entity may have several different types of primary users. For example, the entity's investors may include individuals holding different classes of shares, institutional investors, bond investors, employees with options to buy shares and/or other types of investors. Across the range of possible primary users there may be a broad range of information needs and some may have dissimilar information needs and expectations. For example, some information might be useful to some primary users, but not others. If an entity has many classes of primary users, the financial statements should present and disclose information so as to meet the common information needs of a broad range of those classes.
- 18 Management cannot reasonably be expected to meet all of the information needs of all of the entity's primary users. For example, a single investor might be particularly interested in detailed information about an entity's expenditure in a specific location because that investor may also have a business operating in that location, but such detailed information may be inconsequential for the other primary users.
- 19 Nevertheless, information would usually be expected to be material if it is relevant to either a range of primary users across different classes or to a significant class of primary user (for example a class with a large number of users).

Decisions made by the primary users of financial statements

- 20 The *Conceptual Framework* provides a description of the decisions made by the primary users and their information needs:
- OB2 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. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.
- OB3 Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity.
- OB4 To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.

OB6 However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

21 In developing Standards, the IASB seeks to identify the information that is expected to meet the needs of a broad range of primary users, for a wide variety of entities. Consequently, when management considers what information should be provided in the financial statements, the requirements in IFRS should provide the basis for that assessment. The requirements within IFRS have been developed by the IASB taking into consideration the balance between the benefits of providing information to users of the financial statements and the costs of complying with those requirements. Consequently the cost of applying the requirements in IFRS is not a factor for management to consider when assessing whether information is material. However, it is not sufficient to apply the presentation and disclosure requirements in a Standard mechanically, without considering the entity's specific circumstances, whether the entity's primary users have any special needs and whether the information provided meets or exceeds the needs of an entity's primary users.

22 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;
- (b) considering what decisions they themselves would seek to make and what information they would want as users of financial information in similar situations (ie as if they were external users themselves and did not possess the internal knowledge held by management for example about key risks or key value drivers);
- (c) observing users' or market responses to information or requests for information, for example on particular transactions or disclosures issued by the entity, or responses by external parties such as analysts; and
- (d) observing the types of information provided by entities operating in the same industry. However, while there are similarities between entities in the same industry, it does not mean that the same kind of information will necessarily be material.

23 Financial information is capable of making a difference to decisions if it has predictive value, confirmatory value or both.⁷ The focus of the materiality assessment is whether the information 'could reasonably be expected to influence' decisions made by users rather than whether information is capable of changing their decisions. Information is material if it confirms trends that could reasonably be expected to reinforce decisions made by the primary users. For example, an entity's earnings may have increased in line with expectations and this information may reinforce a decision to buy, hold or sell shares in the entity.

⁷ See paragraph QC7 of the *Conceptual Framework*.