

STAFF PAPER

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Project	Disclosure Initiative: Materiality		
Paper topic	The Materiality Process		
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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 if the final *Practice Statement* should include the process for applying materiality to an entity's financial statements (the Materiality Process) described in this paper.

Guidance proposed in the Exposure Draft

2. The Exposure Draft noted that some interested parties have said that the concept of materiality is 'well understood' and 'guidance on the application of materiality is unnecessary' (paragraph BC7 of the Exposure Draft). These parties said that the main issues regarding application of materiality are behavioural, for example, time pressures on entities and entities' risk aversion. Some parties noted that it is often easier for an entity to include immaterial information in the financial statements rather than monitor whether that information is material and justify the removal of disclosures to auditors or regulators. The Board acknowledged such behavioural issues but observed that guidance may help to counteract this type of

behaviour. The Board noted that if entities are given guidance, they may feel more confident in exercising judgement¹.

3. The Exposure Draft laid out the general characteristics of materiality by discussing:
 - (a) the definition (paragraphs 7–10 of the Exposure Draft) ;
 - (b) the pervasiveness of materiality (paragraph 11 of the Exposure Draft);
 - (c) the use of judgement (paragraph 12 of the Exposure Draft);
 - (d) considerations of users of financial statements and their decisions (paragraphs 13–23 of the Exposure Draft);
 - (e) the qualitative and quantitative, individual and collective materiality assessment (paragraphs 24–29 of the Exposure Draft).

4. The Exposure Draft also discussed aspects of preparing the financial statements in the context of materiality assessments:
 - (a) dealing with immaterial information (paragraphs 34–36 of the Exposure Draft);
 - (b) aggregating and disaggregating information (paragraphs 37–39 of the Exposure Draft);
 - (c) disclosing in the primary financial statements *versus* the notes (paragraphs 40–48 of the Exposure Draft);
 - (d) applying disclosures specified in IFRS Standards (paragraphs 49–53 of the Exposure Draft);
 - (e) reviewing note disclosures at each reporting date (paragraphs 54–55 of the Exposure Draft); and
 - (f) applying materiality to interim reporting (paragraphs 59–60 of the Exposure Draft).

5. The Exposure Draft also included a section on recognition and measurement (paragraphs 61–66 of the Exposure Draft) detailing the application of practical expedients to financial statements, omissions and misstatements, current period

¹ See paragraph BC7 of the Exposure Draft.

misstatements, prior period errors and misstatements made intentionally to mislead (paragraphs 67–79 of the Exposure Draft).

Summary of the feedback

6. Many respondents welcomed the fact that the Exposure Draft gathered together the guidance on applying materiality that already exists in IFRS Standards. However, we received many comments regarding the practicability of the guidance in the Exposure Draft.
7. Some respondents, such as the European Financial Reporting Advisory Group (EFRAG) CL92², asked the Board to focus more on the exercise of judgement:

Furthermore, EFRAG considers that the guidance should be drafted in a more concise and practical way and focus on areas where it is most difficult to exercise judgement on the application of materiality and, in particular, better illustrate how materiality is applied in line with the specific roles of the primary financial statements and of the notes.
8. The International Organization of Securities Commissions (IOSCO) CL95 said that it would be helpful to tie the guidance together by identifying the steps that an entity should follow in applying materiality:

In addition to the included examples, we think it would be helpful if the IASB added a comprehensive illustration that listed or showed the steps that management should go through in applying the various points made in the Practice Statement. This would help to tie its various points together. A step-by-step illustration could help preparers of financial statements in applying the concept of materiality in practice.

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>

9. Many stakeholders requested that the guidance reflect an entity’s practical steps in preparing the financial statements. For example, the Financial Reporting Council (FRC) CL10 commented:

We recommend that the [Practice Statement] focuses instead on the thought *processes* and *steps* that preparers could follow when making materiality judgements and illustrates this with more detailed examples demonstrating how companies have applied this process in practice in a variety of scenarios [emphasis added].

10. The FRC went further and, in their comment letter (CL10), explained their proposed five-step process, describing what preparers should consider in each step.
11. Similarly, SIX Swiss Exchange Regulation (SIX) CL 43 said that it would be ‘valuable to include a comprehensive example to illustrate the thought-process for determining materiality and how the various elements are connected with each other’.
12. We held meetings with preparers, including groups such as the Global Preparers Forum (GPF) and individual preparers from smaller entities. During most of these meetings, preparers (and other stakeholders) suggested that the final IFRS Practice Statement: Application of Materiality to Financial Statements (the final *Practice Statement*) should include a decision-tree that describes the application of judgement to materiality decisions.

Staff analysis

The Materiality Process

13. In the light of the nature of the document exposed—a Practice Statement, we agree with the numerous requests for the Board to include practical guidance in the final *Practice Statement* on applying materiality in the preparation of financial statements and practical guidance on the judgements that an entity is required to make. We think that this would be more successful at promoting the behavioural

change sought by the Board³ than just gathering together the materiality requirements that already exist in IFRS Standards. We recommend that the Board includes in the final *Practice Statement* an overview of the role materiality plays in the preparation of financial statements with a focus on the factors an entity considers when making materiality judgements. We have called this overview the ‘Materiality Process’.

14. The proposed Materiality Process focusses on providing guidance on the application of materiality to presentation and disclosure, recognition and measurement, and assessment of errors⁴ when preparing financial statements.
15. The proposed Materiality Process is not intended to deal with the application of materiality for local regulation purposes. An entity needs to refer to its local guidance, in order to state compliance with local regulation. For example, local regulation may require an entity to correct errors and/or to disclose certain information regardless of materiality or based on different concept of materiality⁵.
16. Finally, reflecting the non-mandatory status of the final *Practice Statement*, the Materiality Process is not intended to mandate entities to strictly follow the identified steps (as if they were *rules* to apply). Judgement is always involved in applying materiality to the financial statements. In our opinion the Materiality Process should be perceived as a *good practice guide*, a group of *principles* aimed at helping a preparer to apply judgement in an efficient way.
17. We presented an early draft of the Materiality Process to the Global Preparers Forum / Capital Market Advisory Committee (GPF/CMAC) meeting and the Accounting Standards Advisory Forum (ASAF) meeting in June and July 2016. We received positive feedback on the Materiality Process, with participants in both meetings agreeing that it reflects how materiality is applied appropriately in practice when preparing financial statements.

³ The Board noted that ‘if management is given guidance to refer to, they may feel more confident in exercising judgement when applying the concept of materiality. Consequently, the issuance of guidance may promote a change in behaviour.’ (paragraph BC7 of the Exposure Draft).

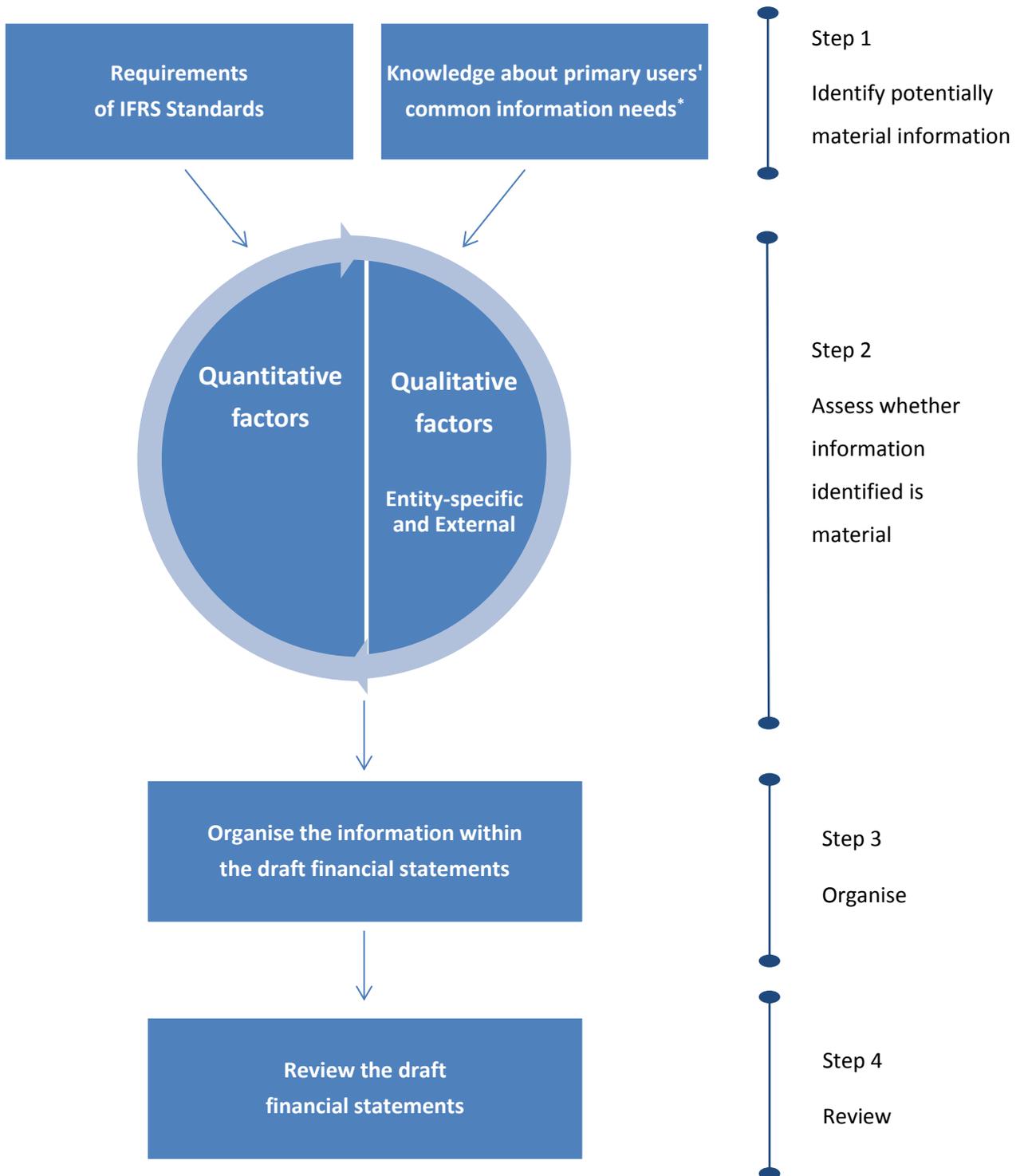
⁴ Being ‘omission from, and misstatements in, the entity’s financial statements’ as defined in paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

⁵ Refer to Agenda Paper 11G *Comparative versus corresponding approach and conflicts with local regulations* for a thorough examination of this subject.

18. Moreover, GPF/CMAC and ASAF members:
- (a) cautioned against presenting the materiality factors as a checklist, which they said could discourage an entity from using judgement.
 - (b) suggested that a case study could be used to illustrate the factors to be considered in applying materiality. However, in our view, such a case study would be incomplete without a full detailed fact pattern needed to make the illustrated materiality judgements, but to provide the full details would be impractical.
 - (c) recommended considering the requirements in IFRS Standards as the starting point in assessing materiality.
19. We considered GPF/CMAC and ASAF members' suggestions in designing the current version of the final guidance. We also took inspiration from the suggested five-step approach provided in FRC's comment letter (CL10). Our proposed Materiality Process is presented in the following paragraphs together with our thinking behind its development and an illustrative diagram.

Overview of the Materiality Process

The illustrative diagram



* Refer to Agenda Paper 11C *Primary users' needs and expectations* for an analysis of what we mean by 'common information needs'.

The identified steps

20. We have identified four main steps in applying materiality in preparing the financial statements. In summary these steps are:
- (a) Step 1—*identify potentially material information*: identify information that could be *potentially material*. Some of this information will be material.
 - (b) Step 2—*assess whether information identified is material*: determine whether the information identified in Step 1 is material.
 - (c) Step 3—*organise the information within the draft financial statements*: organise the material information identified in Step 2 in the draft financial statements in a way that communicates the information effectively and efficiently to the users⁶ of the financial statements.
 - (d) Step 4—*review the draft financial statements*: review the draft financial statements as a whole to determine whether all material information has been identified, including consideration of materiality from an aggregated perspective.
21. The following paragraphs describe each step. In those paragraphs we consistently use the term ‘information’ to refer to the object of the entity’s assessment. The assessment of the materiality of information should be read as implying an assessment of the materiality of both potential *omission* and potential *misstatement* of that information, ie focus on both *presentation and disclosure* and *recognition and measurement* issues. In both cases the assessment will focus on the consequences of omissions and misstatements on the primary users’ ability to understand an entity’s financial position, financial performance and cash flows.
22. We do not expect the outcome of each step for any given piece of information to change radically from period to period, other than to reflect updated or changed information. Therefore an entity can benefit from its earlier assessment provided that it reconsiders any new or updated information.

⁶ 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’.

23. Furthermore we expect the Materiality Process to be as useful for small and medium-sized entities applying IFRS Standards⁷. The assessment of materiality is driven by the nature and significance of the entity's transactions, other events and conditions, and therefore we do not think that smaller entities will be disproportionately affected by the need to assess materiality. Moreover the final *Practice Statement* is intended to provide practical guidance to applying materiality and may be more useful to smaller entities than for larger entities that may have more resources.

Step 1—identify potentially material information

24. Step 1 in our proposed process involves identifying information about an entity's transactions, other events and conditions that might be needed to understanding its financial position and financial performance, therefore its omission or misstatement may be *material*.

25. In identifying this information the entity considers, as a starting point, the requirements of the IFRS Standards that are applicable to its transactions, other events and conditions. When the Board develops an IFRS Standard it already 'seeks to provide the information set that will meet the needs of the maximum number of primary users' (paragraph OB8 of the Conceptual Framework for Financial Reporting (the *Conceptual Framework*)). Consequently the applicable requirements of IFRS Standards provide the starting point for identifying potentially material information.

26. The entity also considers its primary users' common information needs in order to identify any additional information necessary to enable them to understand the impact of the entity's transactions, other events and conditions on the entity's financial position and financial performance. Paragraph 31 of IAS 1 *Presentation of Financial Statements* requires an entity to:

... also consider whether to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other

⁷ We will consider the applicability of the final *Practice Statement* to entities applying IFRS for SMEs in a separate Agenda Paper to be presented to the Board in November 2016.

events and conditions on the entity's financial position and financial performance.

27. The reference to 'primary users' common information needs' should be read, as explained in Agenda Paper 11C *Primary users' needs and expectations*, as being the information needs that are *common* within each category of primary users—existing and potential investors, existing and potential lenders and existing and potential other creditors.
28. Our proposal reflects the discussion with the GPF/CMAC. In June 2016 they highlighted the need to look to the requirements of IFRS Standards as the starting point for identifying potentially material information for the financial statements. The discussions also identified the need to present additional information, as required by IAS 1, which might be needed in order for the financial statements to be understandable to users.
29. The output of the first step is a set of *potentially material* information from which to identify any *material* information.

Step 2—assess whether the information identified is material

30. In Step 2 the entity assesses the information that it has identified in Step 1 to determine whether the information is material. In making this assessment, the entity considers whether its primary users could reasonably be expected to be influenced by the information when making economic decisions on the basis of the financial statements.
31. An entity might conclude that an item of information is material for a number of different reasons. There are no bright lines—ultimately the entity must apply judgement. Nevertheless the proposed Materiality Process identifies some common materiality 'factors' that can be used to help identify when an item of information is material.
32. To help structure the analysis, these factors are organised into the following categories:
 - (a) quantitative; and
 - (b) qualitative, being either entity-specific qualitative and external qualitative.

33. These categories of materiality factors are explained in the following paragraphs. We also include consideration about:
- (a) the benefit of an entity making a quantitative assessment first;
 - (b) the potential need to consider a quantitative assessment when qualitative factors are present; and
 - (c) the qualitative assessment of related party transactions.
34. The output of the second step is the identification of material information. From a *presentation and disclosure* perspective this involves whether to include information in the financial statements *and* how much detail about a particular transaction, other event or condition to include in the financial statements (ie identifying the level of disaggregation an entity would present in the financial statements). From a *recognition and measurement* perspective the output of Step 2 involves the identification of information that, if misstated, would lead to non-compliance with the requirements of IFRS Standards⁸ or fail to provide a fair presentation of an entity's financial position, financial performance and cash flows.

Quantitative factors

35. The entity assesses the size of the impact of the transaction, other event or condition against the entity's financial position and financial performance. In assessing this 'impact' the entity should consider not only those transactions, other events and conditions which are already recognised in the statement of financial position, but also any unrecognised assets and liabilities which ultimately affect the overall perception of the entity's financial position and performance.
36. In making this assessment, the entity assesses whether the impact is of such a size that information about the transaction, other event or condition could reasonably be expected to influence primary users.

⁸ 'Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows' paragraph 41 of IAS 8.

37. Identifying the specific measures against which an entity should make this assessment of size is a matter of judgement. That judgement depends on which measures are of most interest to the primary users of the entity's financial statements. Examples include the entity's revenues, measure of profitability, result of the prior period, etc.

Qualitative factors

38. Qualitative factors are considered as characteristics of a transaction, other event or condition that, if present, will make information about that transaction, other event or condition more likely to influence the economic decisions of the primary users of the entity's financial statements.
39. The presence of a qualitative factor alone will not *necessarily* make the transaction, other event or condition, material, but is likely to increase users' interest in the transaction, other event or condition. The interaction of qualitative factors with quantitative factors is described below.
40. We identified two categories of qualitative factors: entity-specific qualitative factors and external qualitative factors. Both categories influence the materiality assessment in the same way; however we described the two categories separately for clarity and to emphasise the need for an entity to also consider the influence of its external context on the materiality assessment.

Entity-specific qualitative factors

41. Examples of entity-specific qualitative factors include:
- (a) involvement of a related party of the entity;
 - (b) actual or expected non-compliance with laws, regulations or contractual terms (including covenants);
 - (c) uncommon, or non-standard, transaction or other event or condition; and
 - (d) unexpected variation or changes in trends.

External qualitative factors

42. The relevance of information to the primary users of an entity's financial statements can be affected by factors external to the entity. An external

qualitative factor is considered as a characteristic of the *context* of an entity's transaction, other event or condition that, if present, will make information about that transaction, other event or condition more likely to influence the economic decisions of the primary users of the entity's financial statements.

43. External qualitative factors could be constant over time or could be variable. The factors could relate to characteristics of the entity's geographical location, its industry sector, or the wider economy.
44. For example, in some circumstances, an entity's exceptional lack of exposure to a particular risk that other entities in its industry are exposed to, could affect users' decisions about the entity, ie be material information.
45. Due to the nature of the external qualitative factors, entities operating in the same context (eg industry, geographical area, etc.) might identify the same factors.

Quantitative assessment first

46. Although we do not envisage any hierarchy among materiality factors, assessing an item of information from a quantitative perspective first could be an efficient approach to assessing materiality, for the following reason. If an item of information is identified as material on the basis of the size of the transaction, other event or condition involved, the entity does not need to assess that item of information further against other materiality factors.

Interaction of qualitative and quantitative factors

47. An item of information could be identified as material on the basis of one or more materiality factors. In general the more factors that apply to a particular item, or the more significant those factors are, the more likely that the item is material.
48. When an entity assesses whether an item of information is material on the basis of a qualitative factor (either entity-specific or external) the entity also considers the size of the impact on the entity's financial position and financial performance of the related transaction, other event or condition. This is because an item of information might not be material if the size of the impact was so small to be capable of influencing primary users' decisions, irrespective of the presence of qualitative factors. The assessment of size in this context is often complementary to the assessment against qualitative factors.

49. Another way of thinking about this is that the presence of a qualitative factor lowers the threshold for the quantitative assessment and the more significant the qualitative factors, the lower that quantitative threshold will be. That quantitative threshold could even reduce to zero when the qualitative factor identifies a transaction, other event or condition that is likely to be highly scrutinised by the primary users of the entity's financial statements.

Qualitative assessment of related party transactions

50. The inclusion of a related-party transaction in our list of qualitative factors prompted disagreement at the GPF meeting in June. Some GPF members were concerned that identifying a related-party transaction as a material item, without any assessment of the size of the transaction, would lead entities to describe all related-party transactions as material.
51. We agree that a quantitative assessment can be relevant to determining whether information about related party transaction is material. However paragraph 6 of IAS 24 *Related Party Disclosures* states that related parties 'may enter into transactions that unrelated parties would not' and also that 'transactions between related parties may not be made at the same amounts as between unrelated parties'.
52. These circumstances increase the interest of primary users on related party transactions and might lead an entity to conclude that such a transaction is material, regardless of the amount involved.
53. We also note that paragraph 23 of IAS 24 states 'Disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated.'

Step 3—organise the information within the financial statements

54. Step 3 deals with presenting and disclosing information in the financial statements to give it an appropriate degree of prominence.
55. The reason why an item of information is material might affect how the entity presents and discloses it in the financial statements—how it organises the information.

56. An entity should organise the material information within its financial statements in a way that communicates that information effectively and efficiently. IAS 1 describes the basic structure of the financial statements. However IAS 1 requires an entity to exercise judgement when deciding how best to communicate information.
57. An entity should use this judgement to organise the information in a way that:
- (a) emphasises important matters;
 - (b) highlights relationships between information;
 - (c) presents or discloses the information that is appropriate for its type, for example tabular or narrative;
 - (d) avoids duplication of information in different parts of the financial statements; and
 - (e) ensures material information is not obscured by immaterial information.
58. Furthermore, an entity should consider the different roles, contexts and objectives of primary financial statements compared to notes⁹ in deciding whether to present an item of information separately in the primary financial statements, to aggregate it with other information, and/or to disclose the information in the notes.
59. The Board's project on the Principles of Disclosure will consider further the organisation of information in the financial statements.

Step 4—review the draft financial statements

60. In Step 4 an entity reviews the draft financial statements to determine whether they give a fair representation of the entity's financial performance, financial position and cash flows¹⁰. In performing this review, the entity draws on its knowledge and experience of its transactions, other events and conditions to

⁹ Refer to Agenda Paper 11B *Principles of Disclosure—Role of financial statements excluding the notes* presented to the Board in March 2015 and Agenda Paper 11E *Principles of Disclosure—Content of the notes* presented to the Board in April 2015.

¹⁰ 'Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.' (paragraph 15 of IAS 1).

identify whether all material information has been included in the financial statements and with appropriate prominence.

61. This review gives the entity the opportunity to ‘step-back’ and consider the information presented from an aggregated perspective. In performing this review the entity also considers:
 - (a) whether all relevant relationships between information have been identified. Identifying new relationships between information might lead to that information being identified as material for the first time.
 - (b) whether the combination of items of information that are individually not-material could result in information capable of influencing primary users’ decisions (ie accumulation).
 - (c) whether the information presented provides a balanced view of the entity’s financial position, financial performance and cash flows.
62. The review may lead to additional information being included in the financial statements (including identified material information being presented with a greater level of disaggregation) or existing information being reorganised.

Staff recommendation

63. We recommend that the Board includes in the final *Practice Statement* the described ‘Materiality Process’. This recommendation responds to requests by many stakeholders for such guidance.
64. Moreover, we recommend that the Board highlights, in the final *Practice Statement*, that:
- (a) although there is no hierarchy among materiality factors, assessing an item of information from a quantitative perspective first could be an efficient approach to assessing materiality;
 - (b) when an entity assesses whether an item of information is material on the basis of a qualitative factor, it should also consider the size of the impact on the entity’s financial position and financial performance of the related transaction, other event or condition; and
 - (c) in assessing the materiality of information about a related party transaction, an entity needs to consider that there are circumstances that increase the interest of primary users on the transaction and might lead an entity to conclude that such a transaction is material, regardless of the amount involved.

Questions for the Board

Questions

1. Do you agree that the Board should include in the final *Practice Statement* an overview of how materiality is applied, such as that depicted in the four-step 'Materiality Process'?

2. Do you agree with the four proposed steps of the 'Materiality Process':

Step 1—*identify potentially material information*: identify information that is potentially material. Some of this information will be material.

Step 2—*assess whether information identified is material*: determine whether the information identified in Step 1 is material.

Step 3—*organise the information within the draft financial statements*: organise the material information identified in Step 2 in the draft financial statements in a way that communicates the information effectively and efficiently to the users of the financial statements.

Step 4—*review the draft financial statements*: review the draft financial statements as a whole to determine whether all material information has been identified, including consideration of materiality from an aggregated perspective.

3. Do you agree that an entity should consider quantitative, entity-specific qualitative and external qualitative factors in its materiality assessment (Step 2 of the 'Materiality Process')? Should the Board add any other factors for assessing the materiality of information?

4. Do you agree that the Board should highlight in the final *Practice Statement* the consideration in paragraph 64 (ie quantitative assessment first, interaction of qualitative and quantitative factors and qualitative assessment of related party transactions)?

5. Do you have any other comments on the proposed 'Materiality Process'?