IFRS

# STAFF PAPER

**July 2018**

**IASB Meeting**

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| **Project** | **Disclosure Initiative—Principles of Disclosure** |
| Paper topic | Project next steps—accounting policy disclosure |


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## Objective

1. The objective of this paper is to present staff analysis and recommendations to the Board about next steps on the Principles of Disclosure project. Specifically, this paper discusses whether, and how, the Board should develop guidance or requirements to help entities determine which accounting policies to disclose.

## Overview

2. This paper is structured as follows:
   - (a) Background (paragraphs 3-9);
   - (b) Summary of staff recommendations and the approach to staff analysis (paragraphs 10-14);
   - (c) Replacing the concept of significance with the concept of materiality in IAS 1 (paragraphs 15-18);
   - (d) Developing guidance for entities about which accounting policies to disclose (paragraphs 19-37);
     - (i) Defer the development of guidance about the application of materiality to accounting policy disclosure (paragraphs 21-25);

   (ii) Mandatory paragraphs for inclusion in IAS 1 *Presentation of Financial Statements* (paragraphs 26-29);

   (iii) Additional guidance and examples in the Materiality Practice Statement (paragraphs 30-34);

   (iv) Staff recommendation and question for the Board (paragraphs 35-37);

(e) Appendix A—Extracts from the Materiality Practice Statement;

(f) Appendix B—Consultation with the Accounting Standards Advisory Forum (ASAF).

## Background

3. The Board has heard concerns that stakeholders' views differ about which accounting policies are 'significant' and should be disclosed. Consequently, the Board developed and discussed three categories of accounting policies in the 2017 *Disclosure Initiative—Principles of Disclosure* Discussion Paper:

(a) Category 1—accounting policies that are always necessary for understanding information in the financial statements, and relate to material items, transactions or events:

   (i) those that have changed during a reporting period because the entity either was required to or chose to change the policies;

   (ii) those chosen from alternatives allowed in IFRS Standards, for example, the option to measure investment property at either cost or fair value;

   (iii) those developed in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in the absence of an IFRS Standard that specifically applies; and

   (iv) those for which an entity is required to make significant judgements and/or assumptions as described in paragraphs 122 and 125 of IAS 1 in applying the accounting policy;

(b) Category 2—accounting policies that are not Category 1, but also relate to items, transactions or events that are material to the financial statements, either because of the amounts involved or because of their nature; and

(c) Category 3—any other accounting policies used by an entity in preparing the financial statements and not included in Categories 1 or 2.

4. The Board's preliminary view was that the additional guidance, detailed in paragraph 3, would help entities to determine which accounting policies should be disclosed by:

(a) explaining the objective of providing accounting policy disclosures to help entities better understand which accounting policies to disclose, and why; and

(b) describing the three categories of accounting policies and clarifying that an entity is required to disclose only those policies necessary for an understanding of the financial statements (ie Categories 1 and 2); and

(c) explaining that an entity is not required to disclose Category 3 accounting policies.

5. Many respondents to the Discussion Paper agreed that the Board should develop guidance to assist entities in determining which accounting policies to disclose (see ***February 2018 Agenda Papers 11B and 11J***). Many suggested that the guidance should be non-mandatory. Respondents, including some users of financial statements, cautioned the Board about developing overly prescriptive requirements about accounting policies. These respondents thought that any guidance the Board develops should allow entities to exercise judgement and flexibility over the appropriate level of accounting policy disclosure.

6. However, respondents did not support the Board's categorisation of accounting policies. They were concerned that any such requirements would be:

(a) confusing—many respondents stated that it was difficult to distinguish between categories and consequently thought application of these would increase complexity of financial reporting; and

(b) overly prescriptive—many respondents thought that such an approach would limit an entity's ability to exercise judgement with regard to accounting policy disclosure.

7. Few respondents provided alternative approaches to the proposal in the Discussion Paper for the Board to consider. However, most respondents thought that any guidance developed by the Board on this topic should be based on the relevance, usefulness and/or materiality of accounting policies. Further, users of financial statements said that the application of materiality is key to deciding which accounting policies to disclose and thought that materiality should be the basis of any requirements developed by the Board. These users thought it would be useful if the Board develop more guidance on how to determine if an accounting policy is material.

8. While not directly addressing which accounting policies to disclose, the Board has undertaken several activities to help entities to make materiality judgements. These activities may influence the decisions that entities make about which accounting policies to disclose. They included:

   (a) 2014 amendments to IAS 1 *Presentation of Financial Statements* relating to materiality and aggregation. These amendments became effective for annual periods beginning on or after 1 January 2016;

   (b) development of the Making Materiality Judgements: Practice Statement (Materiality Practice Statement) issued in September 2017;

   (c) development of Better Communication: Making Disclosures More Meaningful case studies (issued in October 2017); and

   (d) the separate Disclosure Initiative project on the Definition of Material (Exposure Draft published in September 2017).

9. In its March 2018 meeting, the Board asked the staff to perform the following:

   (a) an analysis of the potential effect on accounting policy disclosures of the recently issued Board publications relating to the application of materiality. In particular, how entities might apply guidance in the Materiality Practice Statement to help make judgements around which accounting policies to disclose; and

(b) a high-level assessment of approaches the Board could take to developing guidance for entities about which accounting policies to disclose.

## Summary of staff recommendations and the approach to staff analysis

### *Staff recommendations*

10. Staff recommend that the Board:

(a) develop an amendment to paragraphs 117 to 124 of IAS 1 to require entities to disclose their material accounting policies rather than their significant accounting policies; and

(b) develop additional guidance and examples for inclusion in the Materiality Practice Statement. These would explain and demonstrate the application of the four-step materiality process to accounting policy disclosure.

### *Approach to staff analysis*

11. Staff agree with those stakeholders who thought that guidance should be developed by the Board to help entities determine which accounting policies to disclose and that such guidance should focus on the application of relevance, usefulness and/or materiality (see paragraphs 5-7).

12. However, paragraph 117 of IAS 1 does not refer to materiality. It states that *'[a]n entity shall disclose its significant accounting policies comprising:*

*a. the measurement basis (or bases) used in preparing the financial statements; and*

*b. the other accounting policies used that are relevant to the understanding of the financial statements.'*

13. Staff think that, in order for the Board to develop guidance about the application of materiality in determining which accounting policies to disclose, the Board should first consider the use of the concepts of significance and materiality in IAS 1.

14. Consequently, this paper has two parts:

    (a) replacing the concept of significance with the concept of materiality in IAS 1 (paragraphs 15-18); and

    (b) developing guidance for entities about which accounting policies to disclose (paragraphs 19-37).

## Replacing the concept of significance with the concept of materiality in IAS 1

15. Staff believe that part of the reason why entities find it difficult to exercise judgement about which accounting policies to disclose is because of the use of the concept of significance as opposed to the concept of materiality in paragraphs 117 to 124 of IAS 1. Further, an entity can also find it difficult to exercise judgement in this area as the Board has no definition for the term 'significant'—ie entities are unable to determine if 'significant' has the same meaning as 'material'. We think this can result in inconsistent application.

16. Staff considered defining the term 'significant'. However, this term is used extensively, and in varying contexts, in IFRS Standards. We think that defining the term within the context of accounting policy disclosure could have unintended consequences for other uses of 'significant' in IFRS Standards.

17. Further, as discussed in paragraphs 5-7, stakeholders have provided feedback that deciding which accounting policies to disclose should be determined through relevance, usefulness and/or materiality. We believe that entities would be better able to exercise judgement over which accounting policies to disclose if there was a clear reference to the concept of materiality in the section of IAS 1 which addresses the disclosure of accounting policies—ie paragraphs 117 to 124 of IAS 1.

18. Consequently, staff recommend developing an approach in which paragraphs 117 to 124 of IAS 1 refer to materiality rather than significance (ie amend paragraphs 117 to 124 to require entities to disclose their material accounting policies). This could be done as an isolated amendment to IAS 1 or as part of other improvements that might arise, for example, from the Primary Financial

Statements project. If the Board agree with this recommendation, our next steps would be to work with other project teams to determine the most effective (and least disruptive) approach to replacing the concept of significance with the concept of materiality in paragraphs 117 to 124 of IAS 1.

### *Staff recommendation and question for the Board*

| **Question 1** |
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| Does the Board agree with the staff recommendation that the Board should develop an amendment to paragraphs 117 to 124 of IAS 1 to require entities to disclose their material accounting policies rather than their significant accounting policies? |

## Developing guidance for entities about which accounting policies to disclose

19. As part of the analysis described in paragraph 9, staff performed outreach with ASAF in April 2018 (see Appendix B). The purpose of this discussion was to help the Board make a more informed decision about how to respond to feedback that guidance on the application of materiality to accounting policy disclosures would be helpful.

20. In light of feedback received from comment letters, outreach and consultation, staff believe that amending IAS 1 to refer to materiality instead of significance may not, in isolation, provide entities with sufficient guidance on which accounting policies to disclose. We think that additional guidance on how to apply the concept of materiality to accounting policy disclosures is also needed. Consequently, we have analysed three approaches the Board could take for the development of such guidance:

    (a) defer any decision-making about developing guidance until the Board has more information about the practical effect of amendments and recent publications relating to materiality (see paragraphs 8, 15-18 and 21-25);

(b) develop mandatory explanatory paragraphs for inclusion in IAS 1 about the application of materiality to accounting policy disclosure (paragraphs 26-29); and

(c) develop additional guidance and examples for inclusion in the Materiality Practice Statement. These would explain and demonstrate the application of the four-step materiality process to accounting policy disclosures (paragraphs 30-34).

### *Defer the development of guidance about the application of materiality to accounting policy disclosures*

21. We think the feedback received about the Board's recent publications (see paragraph 8 and Appendix B) provides evidence that those publications are helpful to entities making materiality judgements. However, the absence of specific guidance about accounting policy disclosures may limit the extent to which entities will be able to apply the Board's recent publications effectively when making judgements about which accounting policies are material and should be disclosed. We think the Board cannot conclude at this time that these recent publications will provide sufficient help to those who support the Board developing guidance on the application of materiality to accounting policy disclosure.

22. Consequently, the Board may want to defer any decisions about developing such guidance for entities until the effect of the Board's recent publications on materiality is known. In addition, it is possible that the proposed amendment to IAS 1 (see paragraphs 15-18) could in itself help entities to apply materiality to accounting policy disclosures.

*Advantage*

23. Deferring any decisions about developing guidance may allow the Board to make a more informed decision about whether further guidance on the application of materiality to accounting policy disclosures is needed.

*Disadvantages*

24. Deferring decision-making would not be responsive to feedback received from users. For example, most users that commented on this topic in response to the Discussion Paper supported the Board developing requirements on the application of materiality to accounting policy disclosures. These users generally thought that accounting policy disclosures are often not useful today and could be improved (see ***February 2018 Agenda Paper 11B***). Similarly, in the March 2018 CMAC meeting, users commented that they often do not find the information included in accounting policy disclosures useful.

25. The recent publications relating to the application of materiality do not directly refer to, or address, accounting policy disclosure. As a result, stakeholders may have more difficulties in applying these publications to determining which accounting policies to disclose than to areas for which the Board has provided specific guidance or examples. Consequently, deferring any Board activity that would help entities to make judgements about how to apply materiality to accounting policy disclosure may not be justified.

### *Mandatory paragraphs for inclusion in IAS 1*

26. As described in paragraph 6, respondents did not support the categorisation of accounting policies that was described in the Discussion Paper. This was because they thought introducing categories was confusing and overly prescriptive. However, these respondents thought that some of the content of the approach was still useful—for example, the ‘Category 1’ considerations might help entities to identify material accounting policies.

27. Consequently, staff have considered developing a series of explanatory paragraphs for inclusion in IAS 1. If the Board were to take this approach, the staff would develop further analysis to determine the detailed content for inclusion in IAS 1. However, by way of example, we would anticipate that such paragraphs would explain how an entity can determine if an accounting policy is material.

*Advantage*

28. In the Discussion Paper, the Board noted that there was a wide range of inconsistent stakeholder views about which accounting policies entities should disclose. Mandatory guidance included as part of IAS 1 would need to be applied by all entities and, consequently, might help entities apply a more consistent approach.

*Disadvantage*

29. Many respondents supported guidance on which accounting policies to disclose being non-mandatory. In most cases, this was because respondents were concerned about requirements being overly prescriptive (see paragraphs 5-7). They thought it important for entities to be able to apply judgement about which accounting policies to disclose in their particular case. Consequently, issuing mandatory guidance in IAS 1 would not be responsive to that feedback.

### *Additional guidance and examples in the Materiality Practice Statement*

30. In the Materiality Practice Statement, the Board introduced an approach to making materiality judgements. This approach (the 'four-step materiality process') explains how an entity might assess materiality in the preparation of financial statements (see Appendix A). Staff believe this four-step materiality process would be useful to apply in determining which accounting policies to disclose.

31. Consequently, the Board could consider using the Materiality Practice Statement to provide guidance on how to apply materiality to accounting policy disclosures. The Board could amend the Materiality Practice Statement to include additional guidance and examples about the application of the four-step materiality process in determining whether an accounting policy is material and should be disclosed. If the Board were to take this approach, the staff would develop further analysis to determine the detailed content for inclusion in the Materiality Practice Statement.

*Advantages*

32. As per paragraphs 5-7, many respondents supported the Board developing guidance on which accounting policies to disclose being non-mandatory. Further, this approach would be responsive to feedback received from some ASAF

members, CMAC members and comment letter respondents that any guidance developed by the Board should not be overly prescriptive. We think this approach would achieve a good balance between providing helpful guidance to entities, whilst avoiding the risk of being overly prescriptive.

33. Including examples of how to apply the four-step materiality process to accounting policy disclosures uses existing publications. We think that using the four-step materiality process may result in a more consistent approach to the application of materiality across accounting policy disclosures and other areas of the financial statements.

*Disadvantage*

34. Staff think that the audience for non-mandatory guidance prepared by the Board may be significantly smaller than the audience for mandatory guidance incorporated into IAS 1. This is because we think there is a risk that some entities might be less likely to spend time on guidance that they are not required to apply. We also think there is a risk that those stakeholders who most need assistance with determining which accounting policies to disclose may not be the same as those that are most likely to consider the Materiality Practice Statement. However, we also think that the inclusion of the Materiality Practice Statement into the Board's bound volumes is helpful in highlighting its content to stakeholders. Consequently, we think the risk of a small audience for this document is lower than for some other types of publication, for example, educational material.

### *Staff recommendation and question for the Board*

35. Staff recommend that the Board develop non-mandatory guidance and examples for entities to use in determining whether an accounting policy is material and should be disclosed. Further, we recommend that the non-mandatory guidance be included in the Materiality Practice Statement.

36. We think this approach achieves a good balance between providing helpful guidance to entities, whilst avoiding the risk of being overly prescriptive.

37. If the Board agree with the staff recommendation, the staff's next steps would be to develop guidance and examples of the application of materiality to accounting policy disclosures for discussion with the Board at a future meeting.

| **Question 2** |
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| Does the Board agree with the staff recommendation that the Board should develop additional guidance and examples for inclusion in the Materiality Practice Statement? These would explain and demonstrate the application of the four-step materiality process to accounting policy disclosures. |

## Appendix A—Extracts from the Materiality Practice Statement

*Presentation and disclosure*

10 An entity need not provide a disclosure specified by an IFRS Standard if the information resulting from that disclosure is not material. This is the case even if the Standard contains a list of specific disclosure requirements or describes them as ‘minimum requirements’. Conversely, the entity must consider whether to provide information not specified by IFRS Standards if that information is necessary for primary users to understand the impact of particular transactions, other events and conditions on the entity’s financial position, financial performance and cash flows.

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### A four-step materiality process

33 The steps identified as a possible approach to the assessment of materiality in the preparation of financial statements are, in summary:

(a) Step 1—identify. Identify information that has the potential to be material.

(b) Step 2—assess. Assess whether the information identified in Step 1 is, in fact, material.

(c) Step 3—organise. Organise the information within the draft financial statements in a way that communicates the information clearly and concisely to primary users.

(d) Step 4—review. Review the draft financial statements to determine whether all material information has been identified and materiality considered from a wide perspective and in aggregate, on the basis of the complete set of financial statements.

## Appendix B—Consultation with the Accounting Standards Advisory Forum ('ASAF')

B1. In responding to the Board's decision made in its March 2018 meeting (see paragraph 9), staff consulted with ASAF about:

(a) the potential effects of recent publications relating to the application of materiality (paragraph B3); and

(b) the Board's next steps—in particular, whether the Board should develop additional guidance about the application of materiality to accounting policy disclosure (paragraphs B4-B6).

B2. This consultation, in addition to the comment letter and outreach feedback received (see paragraphs 5-7), has formed the basis of the staff's recommendation to the Board described in paragraph 35.

### *Potential effects of recent publications relating to the application of materiality*

B3. We received the following views from ASAF members on this topic:

(a) some members thought the recent materiality publications were helpful as they demonstrated clearly the application of materiality in multiple scenarios. One member highlighted the case studies as particularly helpful because they give real life examples;

(b) some members thought that developing specific guidance on the application of materiality to accounting policy disclosures would be useful. One of these members noted that the Materiality Practice Statement does not provide examples of how materiality is applied in determining which accounting policies to disclose and thought it might be helpful to include such examples; and

(c) a few members did not think there would be any additional benefit to the Board developing further guidance in addition to these publications. One member thought that improving accounting policy disclosures is more about changing behaviour and another thought that additional guidance would be of limited benefit because judgement still needs to be applied.

### *Board next steps*

B4. We received mixed views from ASAF members on this topic. This is consistent with the comment letter analysis presented to the Board in February 2018.

B5. ASAF members expressed the following views about whether, and what type of guidance, the Board should develop:

(a) some members thought that developing further guidance about which accounting policies to disclose would be helpful;

(b) some members thought that accounting policy disclosure should not be a priority of the Board because any solution would not significantly affect the disclosure problem; and

(c) one member thought that any guidance developed by the Board should take the form of mandatory requirements. However, some other members disagreed with this and instead supported the Board developing educational materials.

B6. ASAF members expressed the following views about the content of any guidance:

(a) as described in paragraph B3, some members supported specific guidance about the application of materiality to accounting policy disclosures;

(b) some members thought that the Board should focus any guidance on the importance of entity-specific disclosures. One of these members said it is not the volume of accounting policy disclosure that is the issue, but rather the quality of accounting policy disclosure. Another added that part of the problem with accounting policy disclosures is that they are very similar for many entities;

(c) some members thought that any guidance should focus on encouraging or requiring accounting policies to be disclosed when there is an accounting policy choice. One member noted that this approach worked well in their jurisdiction. Some other members cautioned the Board against prohibiting disclosure of any accounting policies because financial statements are often incorporated by reference in other filings; and

(d) one member thought that any guidance developed by the Board should help entities to better understand how accounting policies disclosed in the financial statements are used by users of financial statements.