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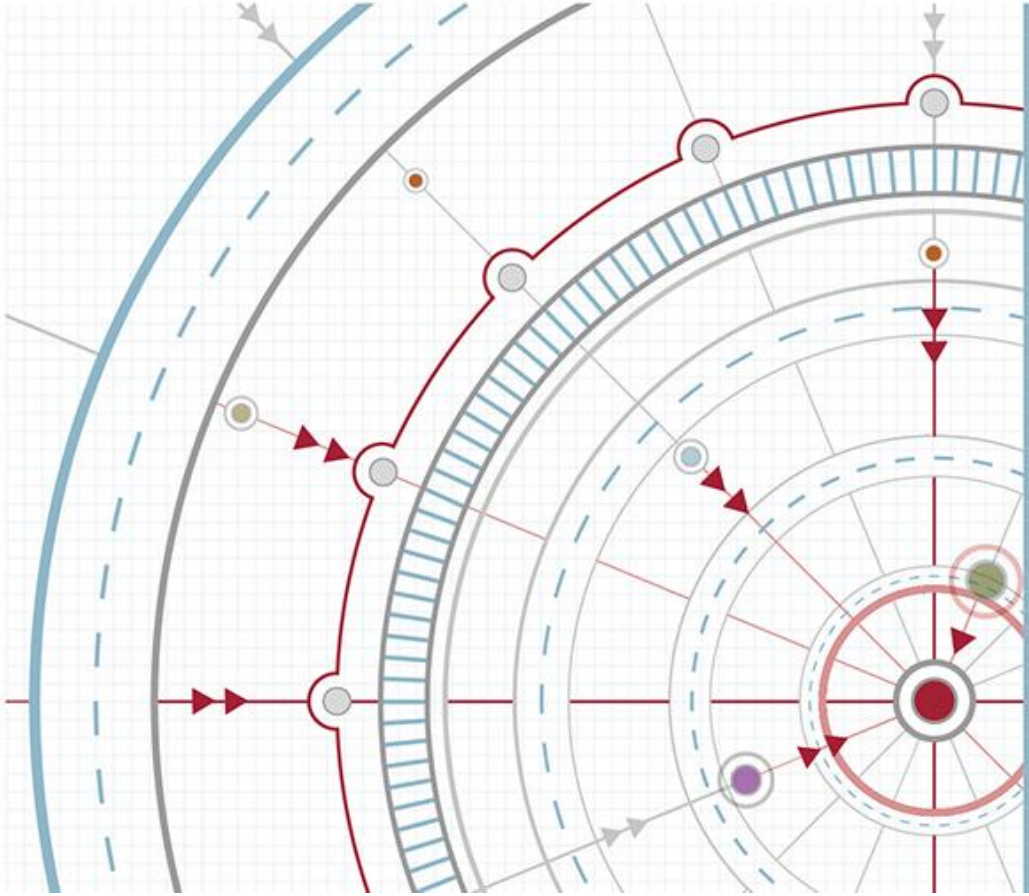

Management Commentary

Slide Deck 3 *Applying materiality*

IFRS Management Commentary

Consultative Group 28 September 2018

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Where we are today

- The *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) revised in 2018 defines material information and provides high-level supporting guidance.

> **Definition of Materiality in the *Conceptual Framework*:**
>
> Information is material if omitting it or misstating it could [reasonably be expected to]* influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.
>
> *The clarification 'reasonably be expected to' is currently in paragraph 7 of IAS 1 *Presentation of Financial Statements*. In a forthcoming amendment to the definition of material, the Board will import that clarification to the definition of materiality in IAS 1 as well as the *Conceptual Framework*.

- The 2010 Practice Statement refers to materiality as a principle to be applied in preparing management commentary. However, it provides no guidance on *how* that principle should be applied.

> **2010 Practice Statement §21: Materiality**
>
> Management should include information that is material to the entity in management commentary. Materiality will be different for each entity. Materiality is an 'entity-specific aspect of relevance'; thus information that is relevant for an entity will also be material.

- IFRS Practice Statement 2 *Making Materiality Judgement* (Materiality Practice Statement) issued in September 2017 provides application guidance on applying materiality in preparing general purpose financial statements. The staff consider this could also be applied to management commentary. In particular, it sets out a possible four-step approach to applying materiality and provides guidance on how these steps could be applied.

> **Materiality Practice Statement §33:**
>
> The steps identified as a possible approach to the assessment of materiality in the preparation of the 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.

How others have approached materiality

- A few national standard-setters refer to or recommend using guidance on materiality in the *Conceptual Framework* or the Materiality Practice Statement.
- Where specific guidance is provided, our research shows that it tends to be anchored into users' decision making or understanding of the business. For example:

Canada: Form 51-102F1 *Management's Discussion & Analysis (MD&A)*
Part 1 (f) What is Material?

Would a reasonable investor's decision whether or not to buy, sell or hold securities in your company likely be influenced or changed if the information in question was omitted or misstated? If so, the information is likely material.

To determine whether information is material, issuers should exercise their best judgment.

Germany: GAS 20 §32, 33

The group management report shall focus on material information. The focus on material information requires, for example, that information about the group's environment is only included in the group management report to the extent that this is necessary for an understanding of the course of business, the position of the group and its expected development.

Why is revision needed?

- Staff are aware that some preparers find the application of materiality to management commentary challenging. For example, the International Integrated Reporting Council (IIRC) Integrated Reporting Implementation Review highlighted this:

> **IIRC - Integrated Reporting Implementation Review: Materiality**
> **'**It is clear from a number of comments that operationalizing the materiality concept is challenging and can be misunderstood or misapplied.'

In order to apply materiality, preparers need an understanding of users' decision-making to determine the information required to support this. The Japanese Institute of Certified Public Accountants (JICPA) has highlighted this as critical to disclosure.

> **JICPA Research Report No. 59: How can corporate reporting practice support long-term oriented behaviour of institutional investors?**
>
> 'For corporate reporting purposes, it is essential to understand not only such investors' attitude and process of evaluating enterprise value, but also major non-financial information required for the financial evaluation.'

- In sustainability reporting, staff have noted examples where this challenge is approached through engagement with users to assess their needs. A downside of this approach is that it creates a '*you didn't ask for it*' defence of non-disclosure when users may not be in a position to know what information they need to ask for.

- The 2010 Practice Statement does not include sufficient application guidance to address these challenges. Reiterating and adapting what is included in the *Conceptual Framework* and the Materiality Practice Statement in the revised Practice Statement will support preparers in assessing what is material for their management commentary.

The staff's proposed approach (1/2)

The staff's proposed approach

- The staff think that the revised Practice Statement should provide clear and practical application guidance for preparers on making materiality judgements by leveraging the *Conceptual Framework* and the Materiality Practice Statement where applicable. Specifically:
  1. the Practice Statement should state that preparers will need to form a strong understanding of the matters and information that would affect users' assessments of the entity's future net cash inflows and of management's stewardship of the entity's economic resources. The Practice Statement should also make explicit the factors that support consideration of materiality in relation to the short, medium and long-term future cash flows of the entity.
  2. the Practice Statement should suggest a more structured approach to applying materiality judgements.

1. Focus on future cash flows and stewardship

- The Materiality Practice Statement reflects the objective of general financial purpose reporting described in the Conceptual Framework and reinforces the link to users' assessments of future cash flows and of stewardship of the entity's resources:

> **Practice Statement 2 §18:**
>
> The expectations existing and potential investors, lenders and other creditors have about returns, in turn, depend on their assessment of the amount, timing and uncertainty of the future net cash inflows to an entity, together with their assessment of management's stewardship of the entity's resources.

- This approach aligns with user decision making without requiring preparers of management commentary to anticipate users' particular decision making strategies, keeping the assessment of materiality internally focused.
- Given the importance of this issue, The staff think it is important to reflect the wording from the Materiality Practice Statement in the revised Practice Statement (or make a cross reference).

The staff's proposed approach (2/2)

2. Supporting a more structured approach to applying materiality judgements:

- The staff note that investment research reports typically cover five or six issues that are regarded as critical to the investment case, providing extensive information around each, but observe that management commentaries tend to cover a broader range of issues in less depth, suggesting that preparers need further support to focus more effectively on what is material.
- The staff think that a two-step initial consideration to materiality fits well with step one of the four-step approach outlined in the Materiality Practice Statement, and the approach of distinguishing the consideration of significant matters and material information merits particular emphasis. A similar approach has recently been incorporated by the Financial reporting Council (FRC).

> **FRC Guidance on the Strategic Report §5.11:**
>
> When considering the application of materiality to non-financial information, entities should as a first step consider whether the particular matter is material to the business and then, if it is, determine the appropriate level of information to disclose in relation to that matter.

Significant matters and material information:

Step 1 of the Materiality Practice Statement—
identify information that has the potential to be material

1. Significant matters:
what's important to the current and future cash flows of the entity?

Additional considerations
- The assessment of materiality in relation to matters where the outcome is uncertain.

2. Material information:
what information would affect a user's assessment of the matter

Additional considerations
- There may be a range of complementary information that could support the assessment of a matter. To determine what information should be provided, the entity will need to consider the disclosures as a whole. *Neutrality* will be considered later.
- Information should not be aggregated to a point where it obscures material trends or factors.

Questions for the Consultative Group

The staff's illustrative drafting on applying materiality in management commentary is provided in Appendix A to this slide deck. We seek your views on the main features of staff's proposed approach to applying materiality in management commentary, in particular:

In particular:

1. Do you agree with the proposed emphasis on making materiality judgements in the context of users' assessments of future cash flows and stewardship?
2. Do you agree with the proposed distinction between significant matters first and material information second?

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APPENDIX A– Illustrative drafting on applying materiality in management commentary

The appendix is provided for illustration only and the staff do not plan to discuss it in detail at the meeting.

Illustrative text

Materiality

A1. Information (qualitative or quantitative) is material to the management commentary if omitting or misstating it could reasonably be expected to influence the decisions that users make in relation to the entity on the basis of the management commentary and financial statements taken together.[1]

A2. It follows that information is material to the management commentary if it could reasonably be expected to influence a user's assessment of the amount, timing, or uncertainty of the entity's cash flows or a user's assessment of management's stewardship of the entity's economic resources.

A3. Examples of information that could reasonably be expected to influence a user's assessment of the amount, timing, or uncertainty of the entity's cash flows are information that indicates that:

a. the financial performance reported in the entity's financial statements does not reveal internal or external factors that have the potential to affect the amount, timing, and uncertainty of the entity's future net cash inflows; or

[1] The clarification 'reasonably be expected to' is currently in paragraph 7 of IAS 1 *Presentation of Financial Statements*. In a forthcoming amendment to the definition of material, the Board will import that clarification to the definition itself.

b. the entity is not capable of sustaining its future net cash inflows in the long term.

A4. In order to determine what information to disclose, the entity first identifies those matters that are significant to the management commentary. In assessing whether a matter is significant to the management commentary, an entity considers the likelihood of the matter crystallising and the potential scale of its effect on the amount, timing, and uncertainty of the entity's future net cash inflows.

A5. Where a significant matter is identified, the entity then assesses what information about that matter is material, and hence needs to be disclosed.

A6. In assessing how much information, and which information, to disclose about a matter, an entity assesses which information is most relevant to the primary users of the entity's management commentary. In doing so, an entity assesses the influence that the information taken as a whole could reasonably be expected to have on users' assessments of the amount, timing and uncertainty of the entity's future net cash inflows and on their assessment of management's stewardship of the entity's economic resources.

A7. The information provided in relation to a matter should be at a level of detail that is sufficient that significant facts and circumstances relating to the matter are not obscured by the aggregation of divergent trends.