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STAFF PAPER

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IASB Meeting

Project	**Disclosure Initiative: Materiality**		
Paper topic	Audience, focus and definition		
CONTACT(S)	Annamaria Frosi	afrosi@ifrs.org	+44 (0)20 7246 6907
	Michael Stewart	mstewart@ifrs.org	+44 (0)20 7246 6922

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 whether members want to change the final *Practice Statement* in the light of comments relating to:

   (a) the audience of the Exposure Draft, ie who should be the addressees of the final *Practice Statement* (paragraphs 2–12);

   (b) the focus of the Exposure Draft, ie whether the final *Practice Statement* should refer only to the concept of materiality for the purpose of financial statements, or whether it should also include other concepts of materiality (paragraphs 13–19); and

   (c) the definition of materiality to be used in the final *Practice Statement* (paragraphs 20–34).

Audience of the final *Practice Statement*

Guidance proposed in the Exposure Draft

2. Paragraph 1 of the Exposure Draft stated that the objective of the Exposure Draft is 'to assist *management* in applying the concept of materiality to general purpose financial statements prepared in accordance with IFRS' Standards [emphasis added]. This objective was reaffirmed in the Basis for Conclusions (paragraph BC16 of the Exposure Draft).

3. The Basis for Conclusions also noted that:

> … although the [Exposure Draft] is aimed at assisting management, it is also likely to help other stakeholders, for example users of financial statements, understand the approach that management follows when making judgements about materiality when preparing financial statements (paragraph BC17 of the Exposure Draft).

Summary of the feedback

4. A common concern raised by respondents relates to the *audience* of the Exposure Draft. Most respondents suggested broadening the audience of the final *Practice Statement*. One such view was expressed by the UK Financial Reporting Council (FRC) in their comment letter (CL10[1]):

> … while the primary audience of the [Exposure Draft] is preparers, in our view it is likely to have more impact if it also addresses other stakeholders such as auditors, regulators and enforcers because their policies and procedures affect the materiality judgements of preparers. Investors may also be interested to understand more about how materiality judgements are made in practice.

5. A similar view was also expressed by others, with some respondents suggesting that to broaden the scope of the final *Practice Statement* it should include others

[1] 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

involved in the financial reporting process, such as auditors, users, regulators and enforcers. In this regard, one such respondent, the Asian-Oceanian Standard-Setters Group (AOSSG), stated:

> … the objective of the Practice Statement should include *explicit references* to other stakeholders who could influence how management would apply materiality in financial statements [emphasis added] (CL90).

6. Respondents suggesting to broaden the audience of the Exposure Draft said that such a Practice Statement could be useful beyond application by management, as it could also promote a common understanding of the role and application of materiality to financial statements among other stakeholders.

7. The Accounting Methodological Centre (AMC) (CL59), as well as the NZASB (CL34), noted that the term 'management' is not defined in IFRS Standards. IFRS Standards normally refer to 'entities'. Accordingly, the AMC suggested replacing 'management' with 'entity' in paragraph 1 of, and throughout the final *Practice Statement*; while the NZASB proposed either to define 'management', or replace the term 'management' with the broader term 'preparers'.

Staff analysis

8. We agree with these respondents that the final *Practice Statement* could be beneficial in guiding other stakeholders involved in the financial reporting process. In our view, such guidance could help such stakeholders understand the approach that management follows when applying materiality when preparing the financial statements.

9. However, we recommend that the Board retains the proposal in the Exposure Draft and addresses the final *Practice Statement* to those involved in the preparation of the financial statements. Our main reasons for this recommendation are:

    (a) this is consistent with the Board's stated objective for publishing the Exposure Draft, that is, to provide guidance to assist entities in applying the concept of materiality to general purpose financial statements prepared in accordance with IFRS Standards; and

(b) other stakeholders, eg auditors or regulators, may have their own guidance on materiality which might additionally address materiality for other purposes, eg for audit. Therefore, addressing the final *Practice Statement* to these other stakeholders might cause confusion, even if the interpretation of the word 'materiality' for financial statement purposes is expected to be consistent across all such stakeholders.

10. We also agree with the respondents who suggested the replacement of the term 'management' with 'entity'. Our main reasons for concurring are:

(a) IFRS Standards normally refer to 'entity' instead of 'management';

(b) the term 'management' is not consistently interpreted, therefore it could be unclear as to which level of management the final *Practice Statement* is intending to address (eg line management, middle management or senior management); moreover it might cause confusion because of the variety of corporate governance structures that exist around the world; and

(c) the term 'preparers', which was suggested as an alternative to 'management'[2], might be associated by some only with 'operating staff'. Those interpreting the term in this way might view it as excluding those who review and approve the financial statements.

Staff recommendation

11. We recommend that the Board:

(a) addresses the final *Practice Statement* only to those involved in the *preparation* of the financial statements. This is consistent with the Board's stated objective for publishing the Exposure Draft, that is, to provide guidance to assist entities in applying the concept of materiality to general purpose financial statements prepared in accordance with IFRS Standards; and

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[2] As suggested by the NZASB (CL34).

(b) acknowledges in the final *Practice Statement* that it may benefit other parties involved in the financial reporting process. That benefit is that it may help those other parties understand the application of materiality in the preparation of the financial statements.

12. We also recommend that the Board replaces the term ‘management’, with the term ‘entity’, throughout the final *Practice Statement*. This would be consistent with the terminology generally used in IFRS Standards. It would also avoid any confusion as to which level of management the final *Practice Statement* is directed at.

Questions for the Board

Question 1—audience of the final *Practice Statement*
Do you agree that the Board should: a) address the final *Practice Statement* only to those involved in the *preparation* of the financial statements; and b) acknowledge, in the final *Practice Statement*, that it may benefit other parties involved in the financial reporting process?

Question 2—‘entity’ instead of ‘management’
Do you agree that the Board should replace the term ‘management’ with the term ‘entity’ throughout the final *Practice Statement*?

Focus of the final *Practice Statement*—other applications of the concept of materiality

Proposed guidance from the Exposure Draft

13. The Exposure Draft has references to other applications of the concept of materiality:

    (a) in paragraphs 4–6: the Exposure Draft discussed other contexts in which the concept of materiality can be applied (eg legal and regulatory). In paragraph 6, the Exposure Draft states:

    > … the way in which the term "materiality" is understood [in these contexts] is expected to be consistent with the way in which the term is expected to be applied to financial reporting.

    (b) in the Basis for Conclusions: the Exposure Draft acknowledged that '… auditors may use similar principles as management does when making judgements in applying the concept of materiality' (paragraph BC18 of the Exposure Draft); there was also clarification that:

        (i) the purposes for which the concept of materiality can be applied can be different:

        > … auditors also apply the concept of materiality for different purposes during an audit than management does during the preparation of financial statements (paragraph BC19 of the Exposure Draft); and

        (ii) the Exposure Draft 'does not directly cover materiality considerations made by auditors for these other purposes' (paragraph BC20 of the Exposure Draft).

Summary of the feedback

14. Respondents' views on other applications of materiality were divided:

    (a) some suggested that the relationship between the application of materiality to financial statements and other applications of materiality (eg audit materiality) should be further explored and better articulated in the final *Practice Statement*. For example, one respondent commented that the final *Practice Statement* should acknowledge:

> … auditors and preparers apply the same concept of materiality in their final assessment of the financial statements (Federation of European Accountants (FEE) CL31),

while another respondent noted:

> … both [preparers and auditors] are focused on the same fundamental issues, ie, what financial information will impact the decisions of users of the financial statements and whether or not the financial statements are free of material misstatement and in the end provide a fair presentation (KPMG CL69).

(b) one suggested that any reference to audit materiality should be deleted from the final *Practice Statement*:

> The guidance on auditor materiality is dealt with by the International Standards on Auditing and/or local legal and regulatory requirements in various jurisdictions. It is outside the scope of this Practice Statement. We therefore suggest that all references to audit materiality and the interaction with the guidance in the Practice Statement should be deleted (PricewaterhouseCoopers (PwC) CL81).

(c) other respondents, such as Deloitte Touche Tohmatsu Limited (DTTL), considered:

> … whether it would be helpful to explain the areas of potential difference [between audit materiality and materiality in financial statements] (…). However, although it is important to understand these differences, (…) the practice statement should focus on the preparation of financial statements, and not their audit (CL76).

15. During outreach we met with a group of auditors to discuss the application of materiality for preparing financial statements and the application of materiality for audit purposes. During the discussion they highlighted that:

    (a) International Standards on Auditing (ISAs) do not define materiality but instead they make reference to the relevant financial framework concept of materiality;

    (b) in their view, preparers and auditors apply a similar approach in assessing materiality: both are focused on achieving a fair presentation of an entity's financial position, financial performance and cash flows; and

    (c) while the guidance in the Exposure Draft could be helpful for auditors and other stakeholders involved in the financial reporting process, the final *Practice Statement* should be addressed only to those involved in the preparation of financial statements because that is the Board's mandate.

Staff analysis

16. We note that a number of stakeholders said that those involved in the preparation of financial statements and their auditors apply the concept of materiality using a comparable approach: they are all focused on what information could influence the decisions of primary users.

17. However, we also note the comments made that the application of materiality for audit purposes is addressed in ISAs and/or local legal or regulatory requirements. We therefore recommend that the Board should not include any reference to other applications of materiality in the body of the final *Practice Statement*. Our main reasons for this recommendation are:

    (a) applying materiality for purposes other than preparation of financial statements is beyond the scope of the final *Practice Statement*; and

    (b) referring to different applications of the concept of materiality might cause confusion.

18. If the Board agrees with our recommendation, we then envisage the following consequences for the drafting:

    (a) remove any reference to other applications of materiality from the body of the final *Practice Statement* and from the Basis for Conclusions. That is, refer throughout the entire document only to applying materiality for preparing financial statements; and

    (b) explain, in the Basis for Conclusions, why the Board decided to focus the final *Practice Statement* only on the concept of materiality applied to the preparation of financial statements.

Staff recommendation

19. We recommend that the Board should refer to applying the concept of materiality only in the preparation of financial statements in the final *Practice Statement*. This will avoid any potential confusion with how the concept of materiality is applied for other purposes.

Question for the Board

Question 3—focus of the final *Practice Statement*
Do you agree that the Board should refer to applying the concept of materiality only in the preparation of financial statements in the final *Practice Statement*?

Definition of materiality to be used in the final *Practice Statement*

Proposed guidance from the Exposure Draft

20. Paragraph 7 of the Exposure Draft includes the definition of materiality, as currently provided in the Conceptual Framework for Financial Reporting (the *Conceptual Framework*)[3]:

> 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. In other words, materiality is an entity-specific aspect of relevance based on the nature or[4] magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. [emphasis added] (paragraph QC11 of the *Conceptual Framework*).

21. The same paragraph in the Exposure Draft acknowledges that 'there are similar definitions [of materiality] in IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*'.

22. Paragraph 8 of the Exposure Draft also refers to IAS 1 to explain that the phrase 'could influence' should take into account how a user 'could *reasonably* be expected to be influenced' [emphasis added] (paragraph 7 of IAS 1) in making economic decisions on the basis of financial statements.

23. Finally, in its Basis for Conclusions, the Exposure Draft acknowledged that:

    (a) the forthcoming Discussion Paper for the Board's Principles of Disclosure project will include a 'discussion on the definition of materiality and whether there is a need to change or clarify that definition' (paragraph BC21 of the Exposure Draft);

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[3] Paragraph 2.11 of the Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* (*Conceptual Framework* ED) published in May 2015, proposes to slightly modify the definition of materiality by including the word 'primary' before the word 'users' and adding the reference to 'general purpose financial reports' after the word users: 'Information is material if omitting it or misstating it could influence decisions that <u>the primary</u> users <u>of general purpose financial reports (see paragraph 1.5)</u> make on the basis of financial information about a specific reporting entity'.

[4] The word 'and' is erroneously referred to in the Exposure Draft, while the *Conceptual Framework* uses 'or'.

(b) the Board 'thinks that it is useful to develop guidance on the application of materiality now, rather than wait until the Principles of Disclosure project has been finished, to address requests for guidance' (paragraph BC21 of the Exposure Draft); and

(c) the Board 'intends to update the content of the [final *Practice Statement*], as necessary, following the completion of its Principles of Disclosure and Conceptual Framework projects' (paragraph BC22 of the Exposure Draft).

Summary of the feedback

24. Some respondents commented on the definition of materiality that was included in the Exposure Draft. Their main concerns related to:

(a) the use of the phrase 'could influence' in the existing definition of materiality; in their view that wording sets the materiality threshold:

> at a quite low level because it would almost always be possible for a primary user to argue that omitted information "could" influence their decisions (Australia and New Zealand Banking Group Limited (ANZ) CL47);

(b) the potential inconsistency of the IFRS Standards definition of materiality with the definition developed by the US Supreme Court that the US national standard-setter, the Financial Accounting Standards Board (FASB), has recently proposed to adopt; in the respondents' view the Board should reconsider its terminology to avoid the uncertainty and confusion that could arise from the existence of two inconsistent definitions:

> the [US Center for Capital Markets Competitiveness (CCMC)] believes that the difference in definitions does indeed create complexities, confusion, and potential litigation risk for Foreign Private Issuers using IFRS for financial statements included in filings with the Securities and Exchange Commission (CCMC CL72).

25. Regarding the timing of the Materiality project in relation to the Principles of Disclosure project, many respondents agreed with the Board's reasoning and were supportive of the guidance on materiality being published before the Principles of Disclosure project is completed. The Australian Accounting Standards Board (AASB) noted:

> The AASB supports the proposal to issue the Practice Statement before the finalisation of the IASB's Principles of Disclosure Project. The AASB thinks deferring the issuance of guidance until the completion of the Principles of Disclosure project would deprive entities from useful guidance in the meantime. The AASB also thinks that the earlier issuance of guidance may encourage some entities to begin undertaking a de-cluttering exercise by providing them with a platform against which to make these decisions (CL89).

26. A number of those respondents expressed agreement on the basis that the Board is not planning to significantly change the definition of materiality in its Principles of Disclosure project. One such view was expressed by the European Financial Reporting Advisory Group (EFRAG) in their comment letter:

> Subject to our understanding that the discussion paper on Principles of Disclosure Project will not have a substantial effect on the proposed guidance, EFRAG supports the IASB's decision to issue the draft Practice Statement before the finalisation of its Principles of Disclosure. However, EFRAG recommends that the IASB closely monitor the outcome of the Principles of Disclosure and other ongoing projects (such as the Conceptual Framework) to ensure that the Practice Statement is updated on a timely basis, if needed (CL92).

27. Some respondents, however, did not agree with the Board's proposal to proceed with guidance on materiality. These respondents are reluctant to see guidance implemented now when there is a possibility of the definition changing within the next few years. They therefore suggested that Board finalise the final *Practice Statement* after reconsidering the definition of materiality.

28. This view was expressed, among others, by the German Insurance Association (GDV):

> … we do not favour finalisation and publication of the planned non-mandatory Practice Statement before the related phase of the Disclosure Initiative, i.e. Principles of Disclosures project, is finalised. It would be of limited value and create unnecessary efforts for preparers and other stakeholders if the Practice Statement would be amended subsequently regarding its core underlying issue, ie the definition of materiality. Only if the Principles of Disclosures project would be significantly delayed, the premature publication of the Practice Statement should be considered (CL75).

Staff analysis

29. Making changes to the definition of materiality in IFRS Standards is not part of the scope of this project. The final *Practice Statement* aims to provide guidance on the *application* of materiality to the preparation of IFRS Standards financial statements. The forthcoming Principles of Disclosure Discussion Paper will include a discussion about the definition of materiality and whether there is a need to change or clarify that definition[5].

30. However, we agree that the interpretation of the phrase 'could influence decisions that users make' in the existing IFRS Standards definition of materiality is integral to the application of the concept of materiality.

31. Guidance on how to interpret 'could influence' already exists in IFRS Standards. Paragraph 8 of the Exposure Draft quoted from paragraph 7 of IAS 1 that the materiality assessment 'needs to take into account how users (…) *could reasonably be expected to be influenced* in making economic decisions' [emphasis added].

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[5] See Agenda Paper 11D *Supporting Material for Agenda Papers 11B and 11C* presented to the Board in April 2015 for the improvements to the definition of materiality suggested within the Principles of Disclosure project. See also Agenda Paper 10H *Materiality*, to be presented to the Board in October 2016, discussing the improvements suggested in the *Conceptual Framework* ED and their interrelation with the amendments being discussed in the Principles of Disclosure project.

32. We suggest that it would be helpful to those applying the final *Practice Statement*, if the explanatory wording of IAS 1 ('could reasonably be expected to be influenced') is consistently used throughout. Our main reasons for this suggestion are:

    (a) it would address the respondents' concerns that almost anything 'could' influence a decision; and

    (b) its inclusion in the final *Practice Statement* would not be a change in the existing requirements of IFRS Standards because the wording is already included in IAS 1.

Staff recommendation

33. We recommend that the Board:

    (a) includes in the final *Practice Statement* the interpretation of the definition of materiality, that an entity should take into account 'how users could *reasonably* be expected to be influenced in making economic decisions' [emphasis added] (paragraph 7 of IAS 1). This guidance already exists in IFRS Standards and in our view would address the concern that almost anything 'could' influence a decision.

    (b) uses consistently throughout the final *Practice Statement* the explanatory wording of IAS 1 ('how users could *reasonably* be expected to be influenced') when referring to materiality. In our view this will further reinforce the way the definition of materiality should be interpreted by entity in preparing IFRS Standards financial statements.

34. We also recommend that:

    (a) the Board does not make any changes to the existing IFRS Standards definition of materiality within this project. The final *Practice Statement* aims to provide guidance on the *application* of materiality to the preparation of IFRS financial statements.

    (b) if the Board decides to change the definition of materiality in another project, the Board should consider then whether there is a need for consequential amendments to the final *Practice Statement* in that project.

Questions for the Board

Question 4—IAS 1 explanatory wording in the final *Practice Statement*
Do you agree that the Board should: (a) include in the final *Practice Statement* the interpretation of the definition of materiality, that an entity should take into account 'how users could *reasonably* be expected to be influenced in making economic decisions'? (b) use consistently throughout the *Practice Statement* the explanatory wording of IAS 1 ('how users could *reasonably* be expected to be influenced') when referring to materiality?

Question 5—definition of materiality
Do you agree that: (a) the Board should not make any changes to the existing IFRS Standards definition of materiality within this project? (b) if the Board decides to change the definition of materiality in another project, that the Board should consider then whether there is a need for consequential amendments to the final *Practice Statement* in that project?