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Disclosure Initiative - proposed guidance on materiality

What you need to know

- The IASB's Disclosure Initiative consists of a number of research and implementation projects aimed at finding ways to improve the effectiveness of disclosures.
- The IASB has proposed guidance to help management apply the concept of materiality when preparing IFRS financial statements.
- Comments on the proposal are due by 26 February 2016.

Highlights

On 28 October 2015, the International Accounting Standards Board (IASB or Board) issued an exposure draft of an IFRS Practice Statement *Application of materiality to financial statements* (ED). The materiality project is part of the IASB's Disclosure Initiative.

The IASB's Disclosure Initiative

Disclosure ineffectiveness is a widely acknowledged problem in current financial reporting practice. It has, therefore, become a priority issue for the IASB, local standard-setters, and regulatory bodies. The growth and complexity of financial disclosure is also drawing significant attention from financial statement preparers, and most importantly, the users of financial statements.

Disclosure ineffectiveness has several dimensions, and the following are often highlighted:

- Not enough relevant information
- Too much irrelevant information
- Poor communication

The objective of the IASB's Disclosure Initiative is to find ways to improve the effectiveness of disclosures.

The Disclosure Initiative is made up of a number of projects as summarised in the table below:

Disclosure Initiative						
Implementation projects			Research projects			Ongoing activities
Proposed amendments to IAS 7	Changes in accounting policies and estimates	Amendments to IAS 1 (completed)	Materiality	Principles of disclosure	Standards-level review of disclosures	Digital reporting

The implementation projects are seeking to address narrow-scope issues, such as specific aspects of IAS 1 *Presentation of Financial Statements*, IAS 7 *Statement of Cash Flows* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The research projects are aiming to address more overarching and pervasive issues. In one of the research projects, the Board is identifying and developing a set of principles of disclosure. In another, the Board will be performing a standard-level review of disclosures in existing standards. The third research project deals with the application of materiality.

How we see it

Disclosure effectiveness is essential to the decision-usefulness of financial statements. The IASB's Disclosure Initiative involves short and longer-term projects that are expected to improve the usefulness of the IFRS financial statements.

The ED on materiality

Background

Many consider the inappropriate application of materiality to be one of the key drivers of disclosure ineffectiveness. In practice, it has been observed that entities disclose immaterial information and omit relevant information, which reduces the decision-usefulness of the financial statements.

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One of the factors suggested as contributing to the problem is the lack of guidance on how to assess materiality in practice, particularly how it should be applied to disclosures in the notes to the financial statements. In the light of this feedback, the IASB decided to undertake a project on materiality with the aim of providing further guidance.

The IASB proposes to provide guidance on the application of materiality in the form of a non-mandatory practice statement.

The proposals

The proposed guidance in the ED is intended to provide explanations and examples to help management apply the definition of materiality. Whether information is material depends on the particular facts and circumstances of the entity, and involves the exercise of management's judgement. As such, instead of introducing prescriptive guidance, the practice statement aims to illustrate the types of factors that management should think about when considering whether and how to disclose information. The proposed guidance does not aim to provide a complete list of considerations for making judgements about materiality.

The scope of the ED covers the preparation of financial statements in accordance with IFRS. It also applies to information that is incorporated in the financial statements by cross-reference.

The ED proposes guidance in three main areas:

- Characteristics of materiality
- How to apply the concept of materiality when presenting and disclosing information in the financial statements
- How to assess whether omissions and misstatements of information are material to the financial statements

General characteristics of materiality

The ED relies on the materiality concept as defined in the *Conceptual Framework for Financial Reporting*:

> "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 and magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report."

The IASB intends to consider whether there are aspects of the materiality definition that require clarification in the principles of disclosure project.

In the ED, the IASB explores materiality by considering the following characteristics:

- *Pervasiveness* – The concept of materiality is pervasive in the preparation of financial statements. Requirements in IFRS must therefore be applied if their effect is material to the whole set of financial statements, while information that is not material need not be disclosed.
- *Judgement* - Materiality judgements require consideration of both the entity's circumstances (and how they have changed as compared to prior periods) and how the information will be used by users of the financial statements.
- *Users of financial statements and their decisions* – The definition of materiality refers to decisions made by the users of financial statements. Having identified the primary users, management should consider the characteristics of those users, including their likely interests and what type of decisions they are making.
- *Qualitative and quantitative assessment* – Applying materiality involves the assessment of both qualitative and quantitative factors. The ED emphasises the importance of qualitative considerations by providing examples in which considering quantitative factors may not be helpful, e.g., in deciding which accounting policies to disclose.
- *Individual and collective assessment* – The assessment of whether information is material or immaterial should be undertaken on both an individual and collective basis.

Presentation and disclosure in the financial statements

The ED proposes guidance to assist management in making judgements on materiality when deciding how to present and disclose information in the financial statements.

The ED proposes guidance in the following areas:

- The context of the materiality assessment, i.e., how the objective of the financial statements relates to materiality decisions
- How to deal with immaterial information and how the disclosure of immaterial information might obscure relevant information
- When to aggregate and disaggregate information
- How to apply materiality when determining whether information should be disclosed in the primary financial statements or in the notes

Omissions and misstatements

Omissions and misstatements of information are material if, individually or collectively, they could reasonably be expected to influence decisions that the primary users of the financial statements make on the basis of those statements.

The ED proposes guidance in the following areas:

- Assessment of the materiality of misstatements
- Current period misstatements versus prior period misstatements
- Intentional misstatements

Next steps

The comment period on the ED closes on 26 February 2016.

How we see it

We encourage stakeholders to provide feedback to the IASB in the form of a comment letter, to contribute to a well-grounded and robust discussion of materiality. Given the role of materiality in financial reporting, the ED deserves attention by all relevant parties - preparers, users, auditors and regulators.

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ED None