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IFRS Developments

Disclosure Initiative – updates on the Materiality Project

What you need to know

- The IASB's *Disclosure Initiative* consists of research and implementation projects that address how the effectiveness of disclosures in IFRS financial statements can be improved.
- The IASB issued a non-mandatory Practice Statement to help entities making materiality judgements when preparing IFRS financial statements.
- The PS proposes a four-step process for applying materiality to an entity's financial statements and includes guidance on how to make materiality judgements in specific circumstances
- The IASB issued the Exposure Draft *Definition of Material* proposing amendments to IAS 1 and IAS 8 to clarify and align the definition of material. Comments are due by 15 January 2018.

Highlights

On 14 September 2017, the International Accounting Standards Board (IASB or Board) issued IFRS Practice Statement 2: *Making Materiality Judgements* (PS) and the Exposure Draft (ED) *Definition of Material*. Both are the output of the Materiality Project which is part of the IASB's *Disclosure Initiative*.

The Better Communication theme

In an attempt to enhance communication in financial reporting, the IASB has made *Better Communication in Financial Reporting* a central theme of its agenda for 2017 to 2021. The *Disclosure Initiative* is part of the *Better Communication* theme, and aims to address how the effectiveness of disclosures in IFRS financial statements can be improved. In addition to the Materiality Project, the two following projects are part of the *Disclosure Initiative*:

- *Principles of Disclosure* – This project seeks to identify and better understand the issues in respect of disclosure and develop a set of new disclosure principles or clarify the existing principles. Its focus is on the general disclosure requirements in IAS 1 *Presentation of Financial Statements* and concepts being developed in the project to revise the existing *Conceptual Framework*. The IASB published a discussion paper in March 2017[1].
- *Standards-level review of disclosures* - This project is to develop a drafting guide for the Board to use when setting disclosure requirements in new and amended standards. Disclosure requirements in existing standards may be reconsidered to improve disclosure effectiveness.

The following two projects have already been completed:

- *Narrow-scope amendments to IAS 1*– In 2014 the IASB made certain amendments to help entities apply judgement when preparing their financial statements.
- *Amendments to IAS 7 Statement of Cash Flows* – The amendments, issued in January 2016, require disclosure of changes in liabilities arising from financing activities.

In addition to the *Disclosure Initiative*, the IASB is examining possible changes to the structure and content of primary financial statements in its *Primary Financial Statements* project. Furthermore, the *IFRS Taxonomy* project, which facilitates electronic reporting of IFRS financial information by classifying information presented and disclosed in IFRS financial statements, is part of the *Better Communication* theme. It enables tagging of the electronic financial information and allows computers to identify, read and extract this information.

The Board is also revising the *Conceptual Framework for Financial Reporting (the Conceptual Framework)* in a separate project in order to improve financial reporting by providing a more complete, clear and updated set of concepts.

The Practice Statement

The PS contains non-mandatory guidance to help entities making materiality judgements when preparing general purpose IFRS financial statements. This guidance is intended to respond to the concerns that financial statements do not contain enough relevant information and, indeed, may include irrelevant information, which have been identified by the Board as two of the major sources of the so called 'disclosure problem'. The PS may also help users of financial statements to understand how an entity makes materiality judgements in preparing such financial statements.

The PS comprises guidance in three main areas:

- General characteristics of materiality
- A four-step process that may be applied in making materiality judgements when preparing financial statements (the 'materiality process')
- Guidance on how to make materiality judgements in specific circumstances, namely, prior period information, errors and covenants and in the context of interim reporting.

Furthermore, the PS discusses the interaction between the materiality judgements an entity is required to make and local laws and regulations. Local laws and regulations may specify additional requirements that can affect the information included in the financial statements. IFRS permits the disclosure of such additional information in order to meet local legal or regulatory requirements, although not material from an IFRS perspective, as long as it does not obscure information that is material.

The PS includes some examples illustrating how an entity might apply the guidance.

General characteristics of materiality

The PS explores materiality by considering the following characteristics:

- *Definition of material* - The objective of financial statements is to provide financial information about the reporting entity that is useful to primary users. An entity identifies the information necessary to meet the objective by making appropriate materiality judgements. The PS refers to the definition of material in the *Conceptual Framework for Financial Reporting*. However, if any changes are made to the definition of material as a result of the proposals in the ED *Definition of Material* (see below), the PS will be amended accordingly.

- *Materiality judgements are pervasive* – Materiality judgements are pervasive to the preparation of financial statements. Entities make materiality judgements in decisions about recognition and measurement as well as presentation and disclosure. Requirements in IFRS only need to be applied if their effect is material to the complete set of financial statements. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRS to achieve a particular presentation. The PS clarifies that an entity does not need to provide a disclosure specified by IFRS if the information resulting from that disclosure is not material, even if IFRS contains a list of specific disclosure requirements or describes them as 'minimum requirements'.
- *Judgement* - Materiality judgements require consideration of both the entity's circumstances (and how they have changed compared to prior periods) and how the information responds to the information needs of its primary users.
- *Primary users and their information needs* – When making materiality judgements, an entity needs to take into account how information could reasonably be expected to influence the primary users of its financial statements and what decisions they make on the basis of the financial statements. Primary users are existing and potential investors, existing and potential lenders and existing and potential other creditors. They are expected to have a reasonable knowledge of business and economic activities and to review and analyse the information included in the financial statements diligently. Since financial statements cannot provide all the information that primary users need, entities aim to meet the common information needs of their primary users (not needs that are unique to particular users or to niche groups).
- *Impact of publicly-available information* – Financial statements must be capable of standing-alone. Therefore, entities make the materiality assessment regardless of whether information is publicly available from another source.

Making materiality judgements

The PS proposes a four-step materiality process to help preparers making materiality judgements. The materiality process describes how an entity may assess whether information is material for the purposes of recognition, measurement, presentation and disclosure.

The four-step process is illustrated as follows in the PS:

Step 1	Identify Identify information about transactions, other events and conditions that has the potential to be material considering the requirements of IFRS and the entity's knowledge of its primary user's common information needs
Step 2	Assess Determine whether the information identified in Step 1 is material considering quantitative (size of the impact of the information against measures of the financial statements) and qualitative (characteristics of the information making it more likely to influence decisions of the primary users) factors in the context of the financial statements as a whole
Step 3	Organise Organise material information within the draft financial statements in a way that communicates the information clearly and concisely (e.g., by emphasising material matters, tailoring information to the entity's own circumstances, highlighting relationships between different pieces of information)
Step 4	Review Review the draft financial statements to determine whether all material information has been identified and consider the information provided from a wider perspective and in aggregate, on the basis of the complete set of financial statements ('step back')

The materiality process considers potential omissions and misstatements as well as unnecessary inclusion of immaterial information. In all cases, an entity focuses on how the information could reasonably be expected to influence the decisions of users of financial statements.

Specific topics

The PS provides guidance on how to make materiality judgements in the following specific circumstances:

- *Prior period information*
  Entities are required to provide prior period information if it is relevant to understand the current period financial statements, regardless of whether it was included in the prior period financial statements. This might lead an entity to include prior period information that was not previously provided (if necessary to understand the current period financial statements) or to summarise prior period information, retaining only the information necessary to understand the current period financial statements.
- *Errors*
  An entity assesses the materiality of an error (omissions and/or misstatements) on an individual and collective basis and corrects all material errors, as well as any immaterial financial reporting errors made intentionally to achieve a particular presentation of its financial statements. When assessing whether cumulative errors (i.e., errors that have accumulated over several periods) have become material an entity considers whether its circumstances have changed or further accumulation of a current period error has occurred. Cumulative errors must be corrected if they have become material to the current-period financial statements.
- *Covenants*
  When assessing whether information about a covenant is material, an entity considers the impact of a potential covenant breach on the financial statements and the likelihood of the covenant breach occurring.
- *Materiality judgements for interim reporting*
  An entity considers the same materiality factors for the interim report as in its annual assessment. However, it takes into consideration that the time period and the purpose of interim financial statements (i.e., to provide an update on the latest complete set of annual financial statements) differ from those of the annual financial statements.

Exposure Draft *Definition of Material*

The Board proposes amendments to IAS 1 and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in a separate ED to clarify and align the definition of material. The proposed amendments intend to improve the understanding of the existing requirements rather than to significantly impact an entity's materiality judgements or financial statements.

Any changes made to the definition of material in IAS 1 and IAS 8 as a result of the proposals in the ED will result in consequential amendments to the PS and the forthcoming revised *Conceptual Framework*.

Next steps

As the PS represents non-mandatory guidance, entities may apply it immediately.

The comment period for the ED *Definition of Material* ends on 15 January 2018.

How we see it

We believe the PS provides guidance that will be helpful when entities make materiality judgements and thus may improve the communication effectiveness of financial statements. Furthermore, it represents a useful reference point for discussions between entities and their auditors or regulators on the assessment of materiality. Although the guidance in the PS is non-mandatory, we encourage entities to consider applying this guidance when preparing their financial statements.

[1] Discussion Paper DP/2017/1, Disclosure Initiative – Principles of Disclosure