STAFF PAPER

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Accounting Standards Advisory Forum

Project	Materiality		
Paper topic	Materiality Judgement Process		
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Purpose of this session

1. The purpose of this session is to obtain advice and comment from ASAF members on a draft 'Four-step Approach' for making materiality judgements when preparing a financial report.

Structure of this paper

2. The paper is structured as follows:

    (a) introduction;

    (b) draft Four-step Approach; and

    (c) questions for ASAF members.

Introduction

3. IAS 1 *Presentation of Financial Statements* requires management to apply materiality judgements when preparing an IFRS financial report. Paragraph QC11 of the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) defines materiality:

> Information is material if omitting it or misstating it could influence decisions that users[1] 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.

4. In October 2015, the Board published an Exposure Draft *IFRS Practice Statement: Application of Materiality to Financial Statements* (draft *Practice Statement*). The objective of the draft *Practice Statement* is to assist management in applying the concept of materiality to general purpose financial reports prepared applying IFRS Standards.

5. Many stakeholders, in their feedback on the draft *Practice Statement*, asked the Board to describe more clearly the judgement process of applying materiality.

6. In response to these requests, we have developed a draft Four-step Approach, including a description of factors we propose management consider when applying materiality. We intend to recommend to the Board that it includes this in the *Practice Statement*.

Four-step Approach

7. Applying materiality judgements is part of the process of preparing a financial report. In developing the following Four-step Approach, we have considered how materiality fits into this process and identified factors that we think management can apply in making a materiality judgement.

Four-step Approach in applying materiality judgements in preparing a financial report

8. Management can consider the following four steps in applying materiality judgements to preparing a financial report:

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[1] Paragraph 2.11 of the Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* (*Conceptual Framework* ED) proposes modifying this definition by including the word 'primary' before the word 'user'. Consequently, in this paper we have referred to 'primary users'.

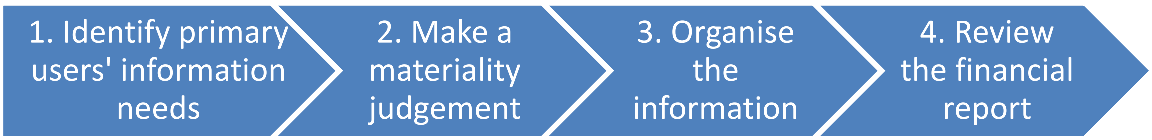
(a) Step—1 identify the primary users and their information needs.

(b) Step—2 assess particular items of information about the entity's financial performance and financial position to decide whether the information is material in the context of the financial report as a whole. In making this assessment consider the impact on the entity's financial performance and financial position of the broader circumstances / environment in which the entity is operating.

(c) Step—3 organise material information within the financial report. Organising this information will involve, for example, determining where the information should be provided; separately on the face of a primary financial statement[2], or in the notes to the financial report.

(d) Step—4 'step back' and review the entire draft financial report to determine, based on management's cumulative knowledge and experience of the entity, whether all material information has been included in the financial report, and whether the financial report gives a balanced picture of the entity's financial performance and financial position. This review includes considering the cumulative materiality of information that was initially assessed as not material in itself when assessed individually in Step 2.

9. The following diagram summarises these four steps:



[2] The term 'primary financial statements' is expected to be defined as part of the *Principles of Disclosure* project. For this paper, the primary statements are the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows. In other words, the primary financial statements comprise the financial statements excluding the notes.

Step 1—identify primary users' information needs

10. Whether information is material is assessed by considering whether including that information could influence primary users' economic decisions. The first step involves:

    (a) identifying the primary users of the entity's financial report; and

    (b) identifying primary users' information needs and their expectations.

11. The *Conceptual Framework* identifies the primary users of an entity's general purpose financial report as the existing and potential investors as well as lenders and other creditors of the entity.

12. The *Conceptual Framework* explains that primary users need information to help them assess the prospects for future net cash inflows to an entity[3]. For this assessment, the *Conceptual Framework* explains, the primary users need information about the resources of the entity, claims against the entity and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to manage the entity's resources. Consequently, when assessing the information needs of the primary users, management considers what information, about the entity and its circumstances, will meet those information needs and thus help the primary users assess the entity's prospects for future net cash inflows.

13. The *Conceptual Framework* notes that an entity may have different subsets of primary users, however an entity's financial report is not expected to meet all information needs of all of the entity's primary users. The financial report should provide information that meets the common information needs of a broad range of primary users.

14. Much of the primary users' common information needs will be consistent from one entity to another, for example, information about revenue, profit, and cash flows from operations. However, some common information needs for an entity's primary users will be specific to that entity.

[3] Paragraph 1.3 of the *Conceptual Framework* ED proposed to add 'and their assessment of management's stewardship of the entity's resources' to highlight the role that information plays in helping primary users' assessment of stewardship.

15. Management should draw on their knowledge of the primary users' information needs and expectations; relevant sources to consider will include:

    (a) past disclosures by the entity. How have past communications, such as interim reports, analysts' briefings or trading statements, created expectations?

    (b) macroeconomic information about the economy, and the industry sector in which the entity operates. Although materiality is an entity-specific assessment, general economic- and industry-sector data can shape primary users' expectations.

Step 2—make a materiality judgement

16. Having identified the entity's primary users and the primary users' information needs and expectations, management assesses information about the entity's financial performance and financial position to determine which information is material and thus should be reported in the financial report. The requirements in IFRS Standards are the starting point for identifying what information should be assessed; these reflect the Board's conclusions of the information that it expects to meet the needs of a broad range of primary users.

17. In making the materiality assessment, management would need to not only draw on their knowledge of the entity but also to consider the potential impact of broader environmental factors. These factors could include changes in the entity's industry sector, the macro-economic environment, the impact of climate change, etc.

18. The following table describes some factors that management may find helpful in making materiality judgements about particular items of information:

Materiality Judgement Process

Quantitative factors

(a) is the item, or the change in the item, that the information describes large or small in the context of a key measure of the entity, or significantly larger or significantly smaller than a broad range of primary users would expect for the entity?

- key measures might include net profit, growth in profit, revenue, etc.

(b) is the information inconsistent with primary users' expectations for the entity?

- for example an unexpected change in a trend, including turning a profit to a loss, or an unexpected change in R&D focus for a technology company

Entity-specific qualitative factors

(c) does the information tell the primary user that the entity has not complied with laws, regulations, and contractual terms, including covenants and that non-compliance has consequences for the entity's financial performance and financial position?

(d) is the information about a related-party transaction, such as management compensation?

(e) has similar information, historically, either confirmed or changed primary users' view of the entity? Have primary users regularly asked for this information?

Environmental qualitative factors

(f) does the information reflect changes in the entity's industry, the wider economy or the environment in which it operates that primary users would expect to affect the entity's financial perofrmance or financial position, or the risks the entity is exposed to?

Step 3—organise the information

19. Management prepares the financial report including all material information identified. In preparing the financial report, management seeks to organise the information in a way that communicates material information efficiently and effectively.

20. IAS 1 describes the basic structure of the financial report. However, IAS 1 allows management to exercise judgement when deciding how best to communicate information.

21. The decisions management makes when organising the material information in the financial report include:

    (a) what material information to present on the face of the primary financial statements;

    (b) what material information to include in the notes to the financial report; and

    (c) in what order to present the notes to the financial report.

22. Materiality is one of the factors management considers when organising the information in the financial report. The forthcoming *Principles of Disclosure* Discussion Paper will discuss other factors to consider.

23. Although information that is not material may be included in a financial report, IAS 1 requires that an entity shall not reduce the understandability of its financial report by obscuring material information with information that is not material. Consequently, when organising the information in the financial report, management ensures that material information is not obscured.

Step 4—review the financial report

24. Management reviews the draft financial report to determine, based on management's cumulative knowledge and experience of the entity, whether all material information has been included in the financial report and with appropriate prominence so that the financial report gives a balanced picture of the entity's financial performance, financial position.

25. This review gives management the opportunity to step back and consider the cumulative materiality of information that was initially considered not material when assessed individually during the earlier stages of preparation. This includes identifying links between a particular piece of information and other pieces of information, which individually may appear immaterial, but collectively are material.

26. Conversely, the step back assessment might lead management to conclude that information that was initially identified as material is not material.

Questions for ASAF members

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1. Do you think the draft Four-step Approach described in paragraphs 8 to 26 will help management identify material information to include in the financial report? i) where do you think more guidance is needed, and what do you think that guidance should say? ii) do you think applying the guidance will appropriately identify material information? If not, what do you think needs to change, and why? 2. Do you think that the draft Four-step Approach could also help management identify immaterial information to exclude from the financial report? i) if not, what additional guidance do you think is needed to help identify whether information is not material and thus could be excluded from the financial report?