

## STAFF PAPER

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Project	Materiality
Paper topic	Aligning the definition and additional paragraphs for IAS 1
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This paper has been prepared by the Staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

### Purpose of the paper

1. This paper asks the IASB to discuss the content and initial drafting of:
  - (a) the alignment of the definition of materiality across IFRS; and
  - (b) the clarifying paragraphs we are proposing to insert into IAS 1 *Presentation of Financial Statements* on the key characteristics of materiality.

We plan to seek public feedback in the *Principles of Disclosure* Discussion Paper on the aligned definition and on the clarifying paragraphs.

### Structure of the paper

2. This paper is laid out as follows:
  - (a) Decisions to date
  - (b) **Issue 1:** Aligning the definition of materiality across IFRS:
    - (i) Staff analysis
    - (ii) Staff recommendation
  - (c) **Issue 2:** Clarifying paragraphs proposed to be inserted into IAS 1:
    - (i) Staff analysis

- (ii) Staff recommendation
- (d) Questions for the IASB
- (e) Proposed timetable
- (f) Appendix: US Supreme Court cases covering materiality decisions.

### Decisions to date

3. At its November 2014 meeting, the IASB discussed the next steps for its Materiality project and tentatively decided:
  - (a) to propose to change the current definition of materiality within IFRS only to align the definitions in IAS 1, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and the *Conceptual Framework for Financial Reporting* with each other.
  - (b) to propose to insert a paragraph/paragraphs in IAS 1 clarifying the key characteristics of materiality.
  - (c) to provide guidance on the application of materiality, which will take the form of a Practice Statement.
  - (d) to wait until further work has been performed on the Review of Standards project before considering possible changes to address the use of inconsistent or excessively prescriptive language in Standards.
  - (e) not to include a reminder in each Standard that the requirements only apply if their application is material.

This paper addresses paragraphs 3(a) and (b).

4. The content of a draft Practice Statement was discussed at the March 2015 IASB meeting. The IASB expressed broad support for the direction and content of the initial staff draft, but made some drafting and structural suggestions. The staff are requesting permission at this meeting to start the balloting process for an Exposure Draft of the Practice Statement (see Agenda Paper 11A).

## Issue 1: Aligning the definition of materiality across IFRS

5. Materiality is currently defined using slightly different wording in the *Conceptual Framework* compared to IAS 1 and IAS 8. However, the substance of the definitions is consistent.
6. In November 2014, the IASB tentatively decided to propose to align the definition across IFRS to provide a single, clear definition. The IASB also considered whether some elements of the existing definitions in the *Conceptual Framework* and IAS 1/IAS 8 should be moved into separate clarifying paragraphs in IAS 1, and expanded on, because they augment the definition of materiality rather than defining the concept.

### Staff analysis

#### ***Starting point for an aligned definition***

7. As a starting point we have used the revised wording of the definition of materiality that is expected to be included in the *Conceptual Framework* Exposure Draft ('ED'). The ED proposes to replace the word 'users' in paragraph QC11 of the existing *Conceptual Framework* with 'the primary users of general purpose financial reports'. We agree with this proposed change and think that this is an appropriate starting point for the aligned definition.
8. The revised wording expected to be included in the *Conceptual Framework ED* is as follows:
 

"Information is material if omitting it or misstating it could influence decisions that the primary users of general purpose financial reports make on the basis of financial information about a specific reporting entity."<sup>1</sup>
9. There are two matters that we think the IASB needs to discuss in more detail, and for which we are suggesting that the IASB should propose amending the definition when it publishes the *Principles of Disclosure* discussion paper. The first is the 'threshold'

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<sup>1</sup> *Conceptual Framework* ED paragraph 2.11 (based on the preballot draft).

issue of what the word ‘could’ in the definition of materiality means, ie how should ‘could influence decisions’ be interpreted. The second is the overemphasis in the definition on ensuring that information is not omitted.

### ***Use of the word ‘could’***

10. In November 2014 the IASB discussed the ‘threshold’ word ‘could’ in the definition of materiality. The word ‘could’ in the definition is interpreted by some as setting a low threshold—ie, that even if the possibility is remote, the decisions of some of the users of the financial report *could* be influenced. The US Supreme Court uses different language in its description of materiality (see paragraph 16) that some think establishes a higher threshold than ‘could influence decisions’ and ensures that information that is clearly immaterial is filtered out.
11. The IASB’s discussion in November 2014 took place without the benefit of staff analysis of the US Supreme Court’s description of materiality. At that meeting the IASB tentatively decided not to propose a change to the definition of materiality, but to clarify (outside the definition) that the word ‘could’ should be interpreted as ‘is likely to’ or ‘could reasonably be expected to’.
12. In drafting the proposed Practice Statement, we found it difficult to explain that ‘could’ really means ‘could reasonably be expected to’ using explanatory paragraphs. We think that if the IASB wants the definition to have the threshold ‘could reasonably be expected to’, then it is more effective to change the definition itself. We note that the wording ‘could reasonably be expected to’ is currently used in paragraph 7 of IAS 1 and paragraph 6 of IAS 8, so the term itself is not new. However, we are concerned that the wording does not currently receive the appropriate level of attention.
13. Some interested parties have told us that the IASB should tighten up the threshold wording ‘could influence decisions’ in the definition of materiality further, for example by using the wording ‘would influence decisions’ or using the wording in the US Supreme Court’s description of materiality, to address concerns about excessive disclosures in the financial statements.

***Planned changes to materiality in US GAAP***

14. The definition of materiality in Concepts Statement 8 (CON 8) is identical to the current wording in our *Conceptual Framework*.<sup>2</sup> This is because the IASB and FASB developed the qualitative characteristics of their respective frameworks together.
15. The FASB has been concerned about a perceived conflict between the definition of materiality in CON 8 and the description that has been used by US Supreme Court, which evolves through case law.<sup>3</sup> The FASB has been concerned that the threshold in the joint definition is too low. Consequently, in November 2014 the FASB tentatively decided to amend the CON 8 definition to align it with the US Supreme Court’s description.<sup>4</sup> Because the CON 8 and *Conceptual Framework* definitions are currently aligned, we have assessed whether the IASB should also consider using the US Supreme Court’s description when considering its own definition of materiality.<sup>5</sup>
16. The US Supreme Court has described materiality, in *TSC Industries v Northway* as:
 

“A fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the ‘total mix of information...’”<sup>6</sup>
17. The difference between the CON 8/IFRS *Conceptual Framework* and Supreme Court definitions is not a simple ‘threshold’ issue of ‘would’ versus ‘could’. There are three main areas in which the Supreme Court’s definition deviates from the definition in the IFRS *Conceptual Framework*:

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<sup>2</sup> CON 8 is not part of the FASB Accounting Standards Codification (ASC) in the same way that the *Conceptual Framework* is not part of IFRS. The ASC does not include any discussion of materiality. In contrast, IAS 1 and IAS 8 both refer to materiality.

<sup>3</sup>

[http://www.fasb.org/cs/ContentServer?c=Document\\_C&pagename=FASB%2FDocument\\_C%2FDocumentPage&cid=1176164583050](http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176164583050)

<sup>4</sup> Concepts Statement 2, which CON 8 replaced, had used this definition. Hence, the FASB is reverting to the Supreme Court definition.

<sup>5</sup> The proposal to replace the word ‘users’ in paragraph QC11 of the existing *Conceptual Framework* with ‘the primary users of general purpose financial reports’ would also cause the words to diverge.

<sup>6</sup> *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976)

*(1) Substantial likelihood/Could*

18. The ‘threshold’ at which information becomes material is an important element of the materiality definition. We consider ‘substantial likelihood’ to be a higher threshold than ‘could’/‘could reasonably be expected to’. In *TSC Industries* the US Supreme Court rejected the ‘could’ threshold as being a poor filter for materiality and not operational in a court setting.

*(2) Viewed by a reasonable investor as having significantly altered the total mix of information/Influence decisions*

19. The IFRS/CON 8 definition focuses directly on the decision-maker (the users) and whether the information could influence their decisions. The US Supreme Court’s description focuses on how a reasonable investor thinks the information affects the total mix of information. Consequently the focus of the US Supreme Court’s description ‘total mix of information’ appears to be wider than the information in the financial statements. Furthermore, the FASB considered the different wording and concluded that it was reasonable to assume that changes in the mix of information will influence a user’s decision. We are not confident these terms can be used interchangeably.
20. The US Supreme Court’s description of materiality also uses the word ‘significant’ when it refers to how the mix has been altered. The staff have observed that the term ‘significant’ appears to have different meanings in different jurisdictions. For example, in the *Oxford English Dictionary* the word means ‘the quality of being worthy of attention, or of importance’.<sup>7</sup> However, on the basis of our outreach, some jurisdictions, including the US, interpret ‘significant’ as anything that is greater than something that is insignificant, ie as referring to relatively small changes. Considered within the context of the US Supreme Court’s description, that description could be interpreted to mean that information is material if there is a high likelihood that it has a *small effect* on the total mix of information.

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<sup>7</sup> *Oxford English Dictionary*

*(3) Reasonable investor/Primary users*

21. The IASB is proposing to change ‘users’ to ‘primary users’ in the definition in the *Conceptual Framework* ED. Paragraph OB5 of the *Conceptual Framework* states that ‘primary users’ encompass more than investors; in particular, they are existing and potential investors, lenders and other creditors.
22. However, like the US Supreme Court’s description, the *Conceptual Framework* also envisages that the primary users act reasonably. In particular, paragraph QC32 states that ‘Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.’

*Summary*

23. We do not support bringing the US Supreme Court’s definition into IFRS, for several reasons.
24. Moving to the US Supreme Court’s description of materiality would change our current definition of materiality (see paragraphs 17-22). On the basis of our outreach, we do not think our existing definition of materiality is causing problems in practice. Furthermore, the IASB must consider the wide variety of regulatory environments, and cannot make decisions based on the parameters of one single jurisdiction.
25. Using the US Supreme Court’s definition might lead to inconsistencies with the decisions recently made in the *Conceptual Framework* project, and with the existing requirements in IFRS.
26. The US Supreme Court’s position as the ultimate arbitrator in the US means that the description used by the US Supreme Court is already a consideration for foreign filers in the US using IFRS. Although we are not aware of any specific difficulties arising from the difference between the US Supreme Court’s description and the CON 8/IFRS definition, constituents will have the opportunity to voice any concerns by responding to the Discussion Paper *Principles of Disclosure*.
27. The role of the IASB is far removed from that of a court. A court must make laws (or apply laws) as a reaction to the facts presented to them after the event. In contrast, standard-setters establish standards following research, with the objective of

promoting high quality reporting, across markets and circumstances. The standard-setter's scope to shape regulation is based on facilitating preparers to produce financial statements that are based on current information, and encompasses a different remit than that of a court. It is therefore not surprising that the two descriptions/definitions of materiality have emerged with different emphasis.

28. There have been a series of cases before the US Supreme Court (including *TSC Industries v Northway*) in which the Court has considered the concept of materiality. However, the US Supreme Court has not considered materiality directly within the context of the disclosure requirements in the financial statements. The cases have been in relation to materiality within the context of public announcements, takeovers etc. Consequently, the US Supreme Court has so far considered the application of materiality within a different context. The staff have provided more information about the cases discussed by the Court in the appendix, in order to provide additional information about the context within which materiality was discussed.
29. The staff think that the FASB's change to the definition in CON 8 may create increased awareness of the concept of materiality. Consequently, there is now an important opportunity to articulate and promote our understanding of the concept, and of any variations with the US definition.
30. We understand why the FASB has reviewed its definition of materiality. However, we think it is better to consider instead whether some of the material in the US Court decisions could be helpfully included in the Practice Statement on application of materiality to the financial statements.

***Use of the word 'would'***

31. We also continue to support the IASB's tentative decision in November 2014 not to use 'would' instead of 'could' in the IASB's definition of materiality, for the following reasons:
  - (a) Many parties in our outreach were in favour of keeping the current definition of materiality unchanged. These parties thought that changing the definition would be unlikely to change the way in which materiality is applied in practice. For example, in the feedback to the ESMA consultation



paper on materiality, it was noted that many constituents think the difference between ‘could influence’ and ‘would influence’ does not reflect any underlying difference in the intended meaning, and would not make a practical difference in decision-making. In addition, it has been noted that ‘could’ and ‘would’ mean the same thing when translated into some other languages.<sup>8</sup> However, others think that ‘would’ is not the same as ‘could’ and might lead to a much higher threshold and one that would be too high to be operational.

- (b) On the basis of our outreach, the staff think that the problems in applying the concept of materiality are generally behavioural, rather than problems resulting from the definition itself. These behavioural problems include time pressures on management, risk aversion, lack of understanding of the importance of using judgement and over-reliance on a checklist-style approach to preparing the financial statements. The staff think that the behavioural problems can best be influenced by providing guidance on the application of materiality in the Practice Statement, rather than by trying to further change the definition.
32. Our fundamental concern is that we should not introduce a different word into the definition unless we are sure of its meaning. Our recommendation is therefore to qualify the definition using words that are already used in conjunction with the definition in IFRS and that we think will be understood.

#### ***Addition of the word ‘obscuring’***

33. A concern raised regularly by IASB members is that the definition and explanations of materiality focus too much on ensuring that entities do not omit information. In other words, they are tilted towards requiring more disclosure.
34. To provide some symmetry to the definition, we think it would be appropriate and helpful to state that information is material if obscuring it, eg by swamping it with immaterial information, could reasonably be expected to influence the decisions made by the primary users. This is also consistent with the additional clarifying paragraphs

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<sup>8</sup> [http://www.esma.europa.eu/system/files/2012\\_525.pdf](http://www.esma.europa.eu/system/files/2012_525.pdf) Question 5a.

proposed to be added to IAS 1 (see Issue 2 in this paper) and the guidance to be proposed in the draft Practice Statement.

### Staff recommendation

35. The staff recommend that the IASB should propose the following definition of materiality in the Discussion Paper *Principles of Disclosure*:

**Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of financial information about a specific reporting entity.**

### Issue 2: Clarifying paragraphs proposed to be inserted into IAS 1

#### Staff analysis

36. In the clarifying paragraphs we suggest bringing together the ancillary clarifying elements from the existing IAS 1, IAS 8 and *Conceptual Framework* definitions, together with additional clarification. We intend the clarifying paragraphs to set out the key characteristics of materiality as a basis for the guidance in the Practice Statement to expand upon. The IASB's discussion about the clarifying paragraphs will also provide a starting point for the IASB's discussion on aggregation, which is linked to the application of materiality (see Agenda Paper 11C).

#### ***Specific elements***

37. For preparers, making judgements about materiality centres on the decision on whether to *include or exclude information* in the financial statements, and also on the way information is to be included (eg if it is aggregated or shown separately). The existing definition of materiality places an emphasis on misstatements and omissions, which the staff think may be seen to encourage excessive disclosure. In order to emphasise that entities should generally exclude immaterial information (or aggregate it with other information), while also ensuring they include all material information, the staff have focused the language of the clarifying paragraphs both on the inclusion and exclusion of material information.

38. The staff think it is also important to emphasise that providing too much immaterial information can obscure useful information and consequently mean that the financial statements are less understandable.
39. In addition, the staff think the IASB should address the issue that many practitioners focus too much on the quantitative aspect of materiality. Quantity is only one of the qualities that may make a piece of information material. The staff therefore think it is important to highlight that materiality considerations include both the *nature and magnitude* of the information.

### **Staff recommendation**

40. The staff recommend that in the Discussion Paper *Principles of Disclosure* the IASB should propose that IAS 1 includes the following definition and clarifying paragraphs:
- X1 Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of financial information about a specific reporting entity.**
- X2 Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need for their decision-making purposes. Consequently, they are the primary users to whom general purpose financial reports are directed.<sup>9</sup> Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.<sup>10</sup>
- X3 Materiality depends on the nature and magnitude of information, considered both individually and collectively with other information, judged in the light of the particular circumstances of the entity.
- X4 If information is included within the financial statements without due consideration of whether it could reasonably be expected to influence decisions made by the primary users, it may obscure material information and inhibit a clear understanding of the entity's business and the issues that it faces.

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<sup>9</sup> Paragraph OB 5 *IFRS Conceptual Framework for Financial Reporting*.

<sup>10</sup> Paragraph QC32 *IFRS Conceptual Framework for Financial Reporting*.

**Questions for the IASB**

Do you agree with the staff recommendation for:

- (a) the proposed definition of materiality (see paragraph 35); and
- (b) the clarifying paragraphs we are proposing to insert in IAS 1 on the key characteristics of materiality (see paragraph 40)?

**Proposed timetable**

June 2015	Expected publication of the Exposure Draft of a draft Practice Statement
Q4 2015	Expected publication of Discussion Paper <i>Principles of Disclosure</i> . This will contain the proposed definition of materiality and the proposed clarifying paragraphs in IAS 1 included in this paper.

## **Appendix: US Supreme Court cases covering materiality decisions**

- A1.     One of the reasons the staff think that it would not be appropriate for the IASB to adopt the US Supreme Court’s definition of materiality is that it arises from cases that do not deal directly with the financial statements. The purpose of this appendix is to outline the circumstances that gave rise to the US Supreme Court’s definition cases, in order to further clarify the staff’s position as outlined in the paper.
- A2.     This is not a comprehensive list of US Supreme Court cases in which the term ‘materiality’ has been discussed. Instead, it highlights the cases that the staff think are most closely related to the discussion in this paper, ie whether information influenced decisions made by the users.

### ***Legal basis***

- A3.     The disclose requirements of the Securities Act 1934 are underlined by the philosophy that ‘there cannot be honest mistakes without honest publicity. Manipulation and dishonest practice of the marketplace thrive upon mystery and secrecy’.<sup>11</sup> § 10 and §14 of the *Securities Exchange Act* and their subsequent rules enacted by the Securities Exchange Committee form the basis on which the US Supreme Court’s materiality decisions are based.
- A4.     §10(b) of the Securities Exchange Act 1934:

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5: Employment of Manipulative and Deceptive Practices" It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of

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<sup>11</sup> H.R.Rep.No. 1388, 73dCong., 2<sup>nd</sup> Sess., 11 (1934).

interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

A5. *Rule 14a-9, promulgated under § of the Securities Exchange Act of 1934*

No proxy solicitation shall be made "Which is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading".

**The facts behind the US Supreme Court cases**

*TSC Industries, Inc., et al., Petitioners, v. Northway, Inc. No 74-1471 (hereafter referred to as TSC Industries)*

A6. Following National's purchase of 34 per cent of TSC's voting securities from TSC's principal shareholder and his family, the principal shareholder and his son resigned from the Board of Directors and were replaced by five National nominees. The Board voted to liquidate and sell all of TSC's assets by exchanging TSC common and preferred stock for National preferred stock and warrants to purchase National common stock. TSC and National then issued a joint proxy statement to their shareholders recommending approval of the plan. It was successful and TSC was placed in liquidation and dissolution and the share exchange was effected.

A7. The respondent (Northway) was a TSC shareholder who claimed that their joint proxy statement was incomplete and materially misleading, and as such was in breach of §14(a) and Rule 14a-9. They maintained that the proxy solicitation was

wrong to leave out unfavourable elements from an investment banking firm report, despite favourable information being included, as well as information that suggested that National was manipulating the stock price.

*Basic Inc. et al. v. Levinson et al. No 86-279. (hereafter referred to as Basic Inc.)*

- A8. Basic Inc originally refined chemicals used by the steel industry. In 1965 or 1966 Combustion Engineering expressed an interest in buying Basic Inc., but refrained because of concerns about antitrust (competition) law. A regulatory change renewed Combustion Engineering’s interest. Throughout 1978 and 1978 Basic three times publicly denied that there were talks with Combustion Engineering, despite ongoing talks. On 18 December 1978 the New York Stock Exchange suspended trading on Basic Inc.’s shares, issuing a statement that Basic Inc. had been approached by another company concerning the possibility of a merger. On 19 December Basic Inc.’s board endorsed Combustion Engineering’s offer of \$46 per share for its common stock.
- A9. The respondents brought a class action on behalf of shareholders who had sold their shares after the first public denial and before the New York Stock Exchange suspended trading. They assert that Basic had made three false or misleading public statements, and as such were in violation of §10(b) of the *Securities Exchange Act* 1934 and Rule 10b-5.

*Virginia Bankshares, Inc., et al. v. Sandberg et al. No 89-1448 (hereafter referred to as Virginia Bankshares)*

- A10. In December 1986 First American Bankshares (FABI) began a ‘freeze-out’ merger with First American Bank of Virginia. It became part of Virginia Bankshares (VBI), a subsidiary wholly owned by First American Bankshares. 15 per cent of VBI was owned by 2,000 minority shareholders. FABI hired an investment banking firm to give an opinion on the appropriate price for these shares. The investment firm recommended \$42 a share, and the merger was approved at that price.
- A11. Virginian law requires that the shareholders must vote on any merger. A statement of information was circulated preceding the shareholders’ meeting. In their proxy

solicitation, the directors urged adoption of the proposal, highlighting the ‘high’ value that had been attributed to the stock.

- A12. The respondent, Sandberg, did not approve of the merger and sought damages following the merger. She maintained that the proxy solicitation violated §14(a) and Rule 14a-9 on the basis that the directors did not believe the share price was high or that the terms of the merger were fair, but had recommended the merger in a bid to remain on the Board.