# STAFF PAPER

**November 2016**

**IASB Meeting**

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| **Project** | **Disclosure Initiative: Materiality** | | |
| Paper topic | Errors | | |
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## Purpose of this paper

1. This paper considers the comments received on the Exposure Draft and should be read together with Agenda Paper 11 *Materiality - Cover Paper*. It asks the Board whether, in the light of comments received, members want to change the guidance provided in the final *Practice Statement* on the application of materiality to errors.

## Guidance proposed in the Exposure Draft

### *Identified misstatements (paragraphs 67–69 of the Exposure Draft)*

2. The Exposure Draft defined 'misstatements' as '*omissions* (ie excluding relevant information), *errors* and *other misstatements* of information (eg describing information ambiguously or obscuring material information)' [emphasis added] (see paragraph 67 of the Exposure Draft). Misstatements are material if 'individually or collectively, they could reasonably be expected to influence decisions that the primary users make on the basis of the financial statements' (paragraph 67 of the Exposure Draft).

3. The Exposure Draft also described 'errors' as:

> … *a type of misstatement* in the entity's financial statements arising from a failure to use, or misuse of, reliable information that: (a) was available when financial

> statements for those periods were authorised for issue; and/or (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements [emphasis added] (paragraph 68 of the Exposure Draft)[1].

### *Current period misstatements (paragraphs 70–73 of the Exposure Draft)*

4. The Exposure Draft provided two examples of misstatements. First, book-keeping errors; for example a mathematical error in an adjusting journal entry, or a double counting or omission of a physical inventory count. Second, when additional relevant information is identified after the preliminary announcement of financial information and/or after the financial statements have been prepared, but before the financial statements are authorised for issue.

5. Paragraph 71 of the Exposure Draft stated that in these situations 'management should amend the financial statements for all material misstatements identified before the entity's financial statements are authorised for final issue regardless of the cost of doing so'.

6. According to the Exposure Draft the assessment of the materiality of errors requires, among other things, 'consideration of the pervasiveness of the misstatements in the financial statements (eg whether they affect numerous line items)' (paragraph 71 of the Exposure Draft).

7. Moreover, as described in paragraphs 72 and 73 of the Exposure Draft,:

> IAS 1 requires an assessment of whether information is material *individually* and *collectively*. Consequently, management first considers whether each misstatement is material, irrespective of its effect when combined with other misstatements. (…) Management then considers whether any misstatements are material on a collective basis. Even if a misstatement is judged not to be material on its own, it might be material when considered with other information [emphasis added].

[1] This description was derived from the definition of 'prior period errors' contained in paragraph 5 of IAS 8 *Accounting Policies, changes in Accounting Estimates and Errors*.

### *Prior period errors (paragraphs 74–76 of the Exposure Draft)*

8. The Exposure Draft also addressed materiality in the context of prior period errors. It referred to the guidance contained in IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*:

    (a) 'an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue' (paragraph 74 of the Exposure Draft quoting paragraph 42 of IAS 8); and

    (b) 'any material prior period errors are corrected retrospectively by amending the comparative information presented in the financial statements unless it is impracticable to determine either the period specific effects or the cumulative effect of the error' (paragraph 75 of the Exposure Draft).

9. It also noted that entities should consider:

> … the effects in the current period of immaterial prior period errors if it is possible that those errors could cause the current period financial statements to be materially misstated (paragraph 76 of the Exposure Draft).

### *Misstatements made intentionally to mislead (paragraphs 77–79 of the Exposure Draft)*

10. The Exposure Draft also discussed the assessment of materiality for misstatements that had been made intentionally to mislead, saying that:

> … if management intentionally misstates items to achieve a particular presentation or result it has done so presumably because it thinks that particular presentation or result could reasonably be expected to influence the decisions of the primary users of the financial statements and *such misstatements are material* [emphasis added] (paragraph 79 of the Exposure Draft).

## Summary of the feedback

11. The guidance in the Exposure Draft prompted comments on:

    (a) the content and nature of the guidance on errors that should be included in the final *Practice Statement*;

    (b) the materiality assessment of 'cumulative errors'; and

    (c) the guidance on 'errors made intentionally to mislead'.

12. IAS 8 defines 'prior period errors' as being the broader group comprising 'omissions and misstatements'[2]. Consistently with IAS 8, from now on in this paper, we refer to 'errors' as encompassing 'omissions *and* misstatements'.

### *Guidance on errors*

13. Some respondents argued that the Exposure Draft simply quoted IAS 1 and IAS 8 requirements on errors without providing any additional practical guidance. They called for improvements in the guidance on when errors are material to the financial statements, and when they are not.

14. One such view was expressed by the Mexican Financial Reporting Standards Board (CINIF):

> The PS includes a long discussion about omissions and misstatements, of which a significant part comes directly from IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. We believe that this section should focus on when an omission or misstatement is material and not repeat what is already in IAS 8 (CL45).

15. Some other respondents, such as Mazars, suggested deleting the existing 'omission and misstatement' section from the final *Practice Statement*:

> We consider that the whole section on omissions and misstatements should be deleted, except for aspects articulating them in the context of the materiality assessment, as both these notions are part of the

[2] 'Prior period errors are *omissions* from, and *misstatements* in, the entity's financial statements for one or more prior periods (…)' [emphasis added] paragraph 5 of IAS 8.

> definition. In particular, we consider that aspects related to governance, such as fraud, internal controls and intentional misstatements are not relevant to the discussion on materiality in this Practice Statement which topic is to help determine whether information, and therefore whether omission or misstatement of information, is material or not (CL39).

### *Cumulative errors*

16. Several respondents asked for additional guidance on cases when the cumulative effect of previously immaterial errors becomes material in the current period. They questioned whether an entity should correct those errors by restating prior period information and whether the cumulative effect, if uncorrected, would be considered as a material error for the current period.

17. For example, an entity has not depreciated its property plant and equipment with very long life for the first periods after recognition, because it has assessed that depreciation as being immaterial. However after a few years, cumulative depreciation has become material.

18. The Financial Reporting Standards Council of South Africa (FRSC) noted that:

> … over time, the cumulative effect of non-compliance [with IFRS Standards] could become material. In practice, there is uncertainty around how the correction should be treated once the cumulative effect of non-compliance is material. If so, then this would mean restating prior year results. This would imply that the financial statements of prior years were materially misstated. However, since these cumulative errors were actually known in the past they were assessed and the correct conclusion was that they were not material. Hence the prior financial statements were not materially misstated. It is only due to circumstances in the current period such as the impact of the current year's non-compliance or a change in the entity's financial position, that the cumulative amount has now become material. Guidance on whether this should

> be a material prior period error requiring restatement or whether this would be a material error of the current period would be very useful (CL40).

19. Moreover, the International Organisation of Securities Commissions (IOSCO) were concerned that the guidance in paragraphs 74–76 of the Exposure Draft on correcting prior period errors in the current period 'conflicts with existing securities regulation in some jurisdictions, which require restatement of prior period filings in certain circumstances' (CL95).

20. IOSCO members went on to observe that:

> … paragraph 76 of the [Exposure Draft] could be read such that, if the correction of a prior period error in the current year would result in a material misstatement to the current year financial statements, then retrospective correction to the prior period financial statements may be required. For example, the accumulation of immaterial errors over several prior periods could aggregate to a material misstatement such that, if it were corrected in the current year, it would cause the current year to be materially misstated. In this instance, members agree that retrospective correction to the prior period financial statements may be required and believe the Practice Statement should more clearly articulate how paragraph 76 aligns to IAS 8 (CL95).

### *Errors made intentionally to mislead*

21. Many respondents expressed concerns about the guidance provided in the Exposure Draft on errors made intentionally to mislead and their interaction with practical expedients. Some also expressed the view that paragraph 41 of IAS 8 (quoted in paragraph 77 of the Exposure Draft) conflicts with the guidance proposed in the Exposure Draft.

22. The Singapore ASC noted that:

> … the proposed guidance suggests that all misstatements made intentionally by management to deliberately achieve

> a particular presentation are material; (…) This appears at odds with paragraph 41 of IAS 8 (…), in that errors made intentionally to achieve a particular presentation are not necessarily material even though they would prevent financial statements from complying with IFRS (CL93).

23. The European Financial Reporting Advisory Group (EFRAG) also observed that the presumption proposed in paragraph 78 of the Exposure Draft[3]:

> … may be perceived to be inconsistent with the guidance contained in paragraph 41 of IAS 8 (…), because it presumes that any intentional misstatement could reasonably be expected to influence the decisions of the primary users of the financial statements. EFRAG therefore recommends the IASB to align the guidance in the draft Practice Statement with the guidance in IAS 8 and consider whether the guidance contained in IAS 8 should be clarified (CL92).

24. The UK Financial Reporting Council (UK FRC) thought there was scope for improvement:

> In practice, it is difficult to distinguish between the deliberate immaterial misstatement (such as the application of the practical expedient in paragraph 64 of the [Exposure Draft]) and the deliberate achievement of a particular result or presentation; in making the misstatement the preparer will know what the impact on results and presentation will be. What matters, as paragraph 78 implies, is whether the impact on results or presentation is material as this makes the misstatement material (CL 10).

25. They go on to say that they would welcome a clarification that ‘a misstatement is not automatically material, just because it is deliberate’ (CL10). Moreover they noted that:

[3] ‘if management intentionally misstates items to achieve a particular presentation or result (…) such misstatements are material’.

> An immaterial error, whether intentional or not, cannot lead to a presentation or result that could reasonably be expected to influence the decisions of the primary users of the financial statements, because, as paragraph 78 of the [Exposure Draft] states, this would make it material. Clearly an error cannot be both material and immaterial (CL10).

## Staff analysis and recommendation

26. We considered the feedback received from respondents as presented in paragraphs 11–25 of this paper.

### *Guidance on errors*

27. Some respondents thought that the final *Practice Statement* should provide guidance to help determine when an omission or misstatement is material, rather than just reproducing the guidance that is in IAS 8. We agree with those respondents because the objective of the document is to provide guidance on the *application* of materiality.

28. We also agree with the UK FRC's observation that, in assessing the materiality of an error, what matters is 'whether the impact on results or presentation is material' (CL10); in other words, whether the fact that information was omitted or misstated could reasonably be expected to influence the decisions' of the primary users of an entity's financial statements.

29. Consequently, the process an entity should follow in assessing the materiality of an error does not differ from the 'Materiality Process' described in Agenda Paper 11D *The Materiality Process* presented to the Board in October 2016. In particular, as described in that agenda paper, the output of the second step of the Materiality Process (ie Step 2—assess whether the information identified is material) involves the identification of information that, if misstated, would lead to non-compliance with the requirements of IFRS Standards or fail to provide a fair presentation of an entity's financial position, financial performance and cash flows.

30. We recommend that, in the final *Practice Statement*, the Board suggests an entity could refer to the Materiality Process in order to assess the materiality of an error.

### *Cumulative errors*

31. Paragraph 5 of IAS 8 defines prior period errors as:

> … omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
>
> (a) was available when financial statements for those periods were authorised for issue; and
>
> (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

32. Therefore, a *material* prior period error occurs when an entity:

    (a) had available, or could reasonably have been expected to obtain, all the information needed to assess the error and its materiality at the time the 'financial statements for those periods were authorised for issue'; and

    (b) on the basis of *that* information could reasonably have been expected to conclude that the error was *material*, but did not do so.

33. According to IAS 8, *material* prior period errors should be corrected:

> … retrospectively in the first set of financial statements authorised for issue after their discovery by:
>
> (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
>
> (b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented (paragraph 42 of IAS 8).

34. A concern raised by some respondents was about how to assess the materiality of a 'cumulative error' from prior periods. That is, an error generated by the accumulation over several periods of errors that were immaterial both in

individual prior periods and cumulatively over all prior periods. A cumulative error is a prior period error that does not meet the definition of *material* prior period error.

35. To assess whether a cumulative error has become material to the current period, an entity bases its evaluation on the information available, or reasonably expected to be available, at the time the *current* period financial statements is authorised for issue. This materiality assessment needs to be performed only if something *new* related to that cumulative error occurred in the current period, eg:

(a) further accumulation of a *current* period error on the prior period cumulative error; or

(b) new information, or more experience, about the *prior* period that could not reasonably have been expected to have been obtained and taken into account in the preparation of the prior period's financial statements.

36. The latter case (paragraph 35(b)) could be an error, but might instead meet the 'changes in accounting estimate' definition and therefore would not be an error. If it was a change in accounting estimate, the entity would recognise the change in accounting estimate in accordance with the guidance included in IAS 8:

> An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error (paragraph 34 of IAS 8).
>
> The effect of a change in accounting estimate (…) shall be recognised prospectively (…) (paragraph 36 of IAS 8).

37. Nevertheless, if, as a consequence of the assessment the cumulative error is assessed as material in the preparation of the current period financial statements, the financial statements would need to be corrected.

38. We therefore recommend that the Board clarifies, in the final *Practice Statement,* that the assessment of the materiality of a cumulative error should be performed on the basis of the conditions existing at the time the financial statements for that period are authorised for issue.

39. Some respondents asked the Board to make clear whether an error relating to a prior period that became material in the current period should lead to a restatement of comparatives or be corrected in the current period. We agree that it might be helpful to provide guidance on this point, however this would be the provision of guidance on how to correct such an error, whereas the focus of the final *Practice Statement* is on the application of materiality.

40. We also note that IOSCO expressed concern that guidance in the Exposure Draft might conflict with regulations in some jurisdictions that require the restatement of prior period financial statements in some circumstances. This concern does not relate to the proposed guidance on how to apply materiality to errors, but to the discussion in the Exposure Draft about how to correct material errors.

41. We therefore recommend that the final *Practice Statement* does not include any guidance on how to correct a material cumulative error. The focus of the final *Practice Statement* is on the guidance on applying materiality rather than describing the adjustments required to correct material errors.

### *Errors made intentionally to mislead*

42. The Exposure Draft included some wording implying that if management intentionally misstates or omits information to achieve a particular presentation or result such errors are always material (paragraph 78 of the Exposure Draft).

43. It might appear reasonable to presume that if management acts in that way, it 'has done so (…) because it thinks that particular presentation or result could reasonably be expected to influence the decisions of the primary users of the financial statements', and, therefore, conclude that such errors are material.

44. However, we disagree with this presumption because it would appear at odds with paragraph 41 of IAS 8 which acknowledges that an error made intentionally to achieve a particular presentation could be immaterial:

> Financial statements do not comply with IFRSs if they contain either material errors or *immaterial errors made intentionally to achieve a particular presentation* of an entity's financial position, financial performance or cash flows [emphasis added] (paragraph 41 of IAS 8).

45. Besides, IAS 8 requires an entity to correct all errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Consequently, in order to decide whether an entity's financial statements need to be corrected, there is no need to assess whether an error made intentionally to achieve a particular presentation is material.

46. Therefore we recommend that the Board:

    (a) removes from the final *Practice Statement* the wording implying that if management intentionally misstates or omits information to achieve a particular presentation or result such errors are always material (paragraph 78 of the Exposure Draft); and

    (b) includes a reminder, in the final *Practice Statement*, that IAS 8 requires an entity to correct all errors made intentionally to achieve a particular presentation, regardless of their materiality.

47. Finally, some respondents observed that, in practice, it might be difficult to distinguish between book-keeping expedients that have an immaterial effect and immaterial errors made intentionally to achieve a particular presentation.

48. Book-keeping expedients are book-keeping shortcuts designed to reduce the costs of record-keeping without causing material impact on the financial statements[4].

49. According to the requirements in IAS 1, financial statements shall 'present fairly the financial position, financial performance and cash flows of an entity' (paragraph 15 of IAS 1). Fair presentation requires 'faithful representation of the effects of transactions, other events and conditions' in accordance with the Conceptual Framework for Financial Reporting (*Conceptual Framework*) (paragraph 15 of IAS 1). The *Conceptual Framework* in turn specifies that a faithful representation needs to have three characteristics: 'it would be complete, neutral and free from error' (paragraph QC12 of the *Conceptual Framework*).

50. Errors made intentionally to achieve a particular presentation are those that lead an entity to fail to comply with the neutrality of the presentation of its financial

[4] As noted in Agenda Paper 11D *Recognition and measurement*, the Exposure Draft used the term 'practical expedient' when describing a book- keeping expedient applied by an entity. IFRS Standards use the term 'practical expedient' when referring to a specific simplified accounting treatment explicitly permitted by an IFRS Standard for cost benefit reasons. To avoid any ambiguity and confusion we consistently use the term 'book-keeping expedient' in this agenda paper.

position, financial performance and cash flows. According to the *Conceptual Framework*:

> A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users (paragraph QC14 of the *Conceptual Framework*).

51. We recommend that the Board highlights, in the final *Practice Statement*, the differences between book-keeping expedients and immaterial errors made intentionally to achieve a particular presentation. An error made intentionally to achieve a particular presentation, whether material or not, lacks the neutrality required for a faithful presentation of an entity's financial position, financial performance and cash flows.

52. This further clarification will address respondents' concerns and complete the guidance provided in the final *Practice Statement* about the application of materiality to errors.

## Questions for the Board

**Question 1—guidance on errors**

Do you agree that the *Practice Statement* should suggest that entities apply the Materiality Process (as described in Agenda Paper 11D presented to the Board in October 2016) in order to assess whether an error is material?

**Question 2—cumulative errors**

(a) Do you agree that, in the final *Practice Statement*, the Board should clarify that the assessment of the materiality of a cumulative error should be performed on the basis of the conditions existing at the time the financial statements for that period are authorised for issue?

(b) Do you agree that the final *Practice Statement* should not provide any guidance on how to correct a material cumulative error?

**Question 3—errors made intentionally to mislead**

Do you agree that, in the final *Practice Statement*, the Board should:

(a) remove the guidance implying that if management intentionally misstates or omits information to archive a particular presentation or result such errors are always material;

(b) include a reminder that paragraph 41 of IAS 8 requires an entity to correct all errors made intentionally to achieve a particular presentation, regardless of their materiality; and

(c) explain that an error made intentionally to achieve a particular presentation is one that leads an entity to fail to comply with the *neutrality* of the presentation of its financial position, financial performance and cash flows?