IFRS

STAFF PAPER

November 2016

IASB Meeting

Project	**Disclosure Initiative: Materiality**		
Paper topic	Recognition and measurement		

CONTACT(S)	Aisling Carney	acarney@ifrs.org	+44 (0)20 7246 6480
	Michael Stewart	mstewart@ifrs.org	+44 (0)20 7246 6922

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 the final *Practice Statement* should include guidance on the application of materiality in the context of recognition and measurement throughout, rather than as a separate section. It also asks the Board if it agrees with proposed changes to the guidance on the role of practical expedients in the application of materiality.

Guidance proposed in the Exposure Draft

Recognition and measurement

2. The Exposure Draft contained a small section on the application of materiality in the context of the recognition and measurement of information. The Exposure Draft also discussed the link between materiality and some practical expedients that entities use in preparing financial statements.

3. The Exposure Draft noted, in paragraph 61, that:

> Much of the content of this [draft] Practice Statement focusses on providing guidance on the application of materiality when presenting and disclosing information in the financial statements. However, similar considerations

> also apply to the recognition and measurement of the information that is provided in the financial statements. IFRS Standards recognition and measurement requirements are applied to information if their effect is material to the financial statements.

4. The Exposure Draft went on to discuss the recognition of material or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flow. We discuss issues relating to the application of materiality to errors in Agenda Paper 11A *Errors*.

Practical expedients

5. The Exposure Draft stated that 'IFRS does not specify requirements for an entity's internal record keeping procedures' (paragraph 63 of the Exposure Draft). However, the Board said, in the sub section 'Practical expedients' (paragraphs 63–66 of the Exposure Draft), that an entity may:

> … decide not to apply a requirement in a Standard when it records a particular item, provided it later makes an adjustment to ensure the information is in accordance with IFRS for financial reporting purposes (paragraph 63 of the Exposure Draft).

6. The Exposure Draft included examples of when this may be the case (paragraphs 63–65), including when:

> …an entity might maintain a periodic inventory system and then later adjust amounts for the purchases and inventory for financial reporting purposes based on physical stock counts;
>
> …An entity might have an internal policy of capitalising capital expenditure only in excess of a specified threshold and recognising smaller amounts as an expense…;
>
> …It is conventional for entities to select a monetary unit, for example CU 1,000, and to round to the nearest unit when preparing the financial statements.

Summary of the feedback

Recognition and measurement

7. We received mixed feedback on the usefulness and appropriateness of including a section on recognition and measurement in the final *Practice Statement*. Many of the respondents felt that the guidance in the Exposure Draft was not sufficient. However, there were a variety of the opinions on how best to remedy this shortcoming.

8. Some respondents thought that recognition and measurement is an important part of preparing financial statements and materiality plays a key role in this process. One suggested that the final *Practice Statement* 'provide[s] a thorough description covering topics on applying the concept of materiality under the IFRS as well as serve as a useful guidance on applying the concept of materiality in recognition and measurement' (The Japanese Institute of Certified Public Accountants (JICPA) CL55). Another thought that 'a publication regarding the application of materiality (…) should be comprehensive and should relate to the application of materiality in recognition and measurement in equal prominence as to its application in disclosure and presentation' (Israel Accounting Standards Board (Israel ASB) CL14).

9. The Australian Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) suggested areas in which the final *Practice Statement* could address circumstances such as when:

> … there is no active market or identifiable cash flows for an asset; it may be impossible or extremely complicated and expensive to measure the recoverable amount, particularly under the requirements of IFRS. The IASB could consider conditions where materiality be invoked to use an estimate of fair value or to continue to carry the assets at historic cost where this has been used in the past. A possible precedent for this is IAS 34, which allows more latitude in the application of materiality to estimates in interim financial statements (paragraph 60). Could a similar precedent be applied to avoid the need for expensive and

> time-consuming valuation, where the information is of little value to users? If the IASB consider existing guidance adequate, the inclusion of an example would be useful (CL8).

10. The Confederation of Swedish Enterprise (SEAG) stated that:

> The proposed guidance concerning Recognition and measurement is very brief. As materiality issues not only concern presentation and disclosures, but too a large extent also recognition and measurement, an extension of this section would be of much help to preparers. For example, it would be beneficial if the guidance contained a discussion on the assessment of materiality when selecting measurement inputs (CL49).

11. However, some respondents said that it is not necessary to include a section on recognition and measurement in the final *Practice Statement*. Some shared the view of the Canadian Accounting Standards Board (AcSB), who noted that:

> Developing more extensive guidance on materiality in the context of recognition and measurement would take some time. Recognition and measurement, as well as corrections of omissions and misstatements, are outside the scope of the Disclosure Initiative (CL44).

12. KPMG thought that issues associated with the application of materiality to recognition and measurement are not as pressing as application of materiality to disclosure and presentation:

> We (…) believe that recognition and measurement issues are not as pressing as application of materiality in the context of disclosures and could be dealt with at a later stage (CL69).

13. Others, such as the Australian Accounting Standards Board (AASB), suggested that the focus of the final *Practice Statement* should be exclusively on presentation and disclosure. They argued that, considering the Materiality project is part of the Disclosure Initiative project,

> … the guidance in the Practice Statement largely pertains to materiality as it applies to presentation and disclosure, rather than recognition and measurement; for example, the discussion in paragraphs 7 – 10 of the ED (IFRS definition of materiality) does not explicitly acknowledge that the concept of materiality applies also to recognition and measurement to the same extent as it does to presentation and disclosure, and the illustrative examples included relate to presentation or disclosure, rather than recognition or measurement. The AASB supports the focus of this Practice Statement being with regard to presentation and disclosure, but encourages the IASB to make this clear upfront in the document, for example, within the objective of the Practice Statement (CL89).

Practical expedients

14. We did not receive many direct comments on practical expedients presented in the Exposure Draft. In the main, respondents asked that the use of practical expedients is described in the context of the process that preparers go through when preparing financial statements. KPMG said:

> [The] discussion of recognition and measurement, including explanations of practical expedients, could be confusing if the intended focus of the Practice Statement is materiality in the context of disclosures. If such discussion is retained, we suggest to put it in context of the process that the preparer is expected to follow in making their materiality judgement. In particular, it would be helpful to acknowledge management responsibility for maintaining complete and accurate books and records and the interaction of such requirements with the preparation of financial statements that include all material disclosures (CL69).

15. Other respondents thought the term ‘practical expedients’ could be confusing. As the Accounting Standards Board of Japan (ASBJ) noted:

> … considering the term 'practical expedients' is often used to explain that the Standard permits simplified accounting treatments for cost-benefit reasons (for example, scope exceptions set out in IFRS 16 Leases), we think that it would be desirable if the IASB explains the difference between the two types of practical expedients in the proposed document (CL17).

16. Others asked that the final *Practice Statement* should include more discussions of specific examples of practical expedients. In particular, the Singapore ASC (CL93) questioned whether the practical expedients in IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* that permit their requirements to be applied on a portfolio basis were in fact examples of the application of materiality. The Singapore ASC suggested that the Board could 'consider the merits of characterising the portfolio approach as an example of a practical expedient' (CL93).

17. We heard concerns, during outreach meetings with stakeholders, that the discussion on practical expedients in the Exposure Draft focused on an entity's internal records. Some stakeholders felt that the discussion was inappropriate and should not be included in the final *Practice Statement* because, as noted in the Exposure Draft, it is beyond the scope of IFRS Standards to specify how information is recorded internally.

Staff analysis

Recognition and measurement

18. We note that some preparers say they do not need guidance in applying materiality in the context of recognition and measurement. Some Standard Setters and auditing firms questioned the appropriateness of a discussion on recognition and measurement in the Exposure Draft because the Practice Statement forms part of the Disclosure Initiative and should therefore focus exclusively on disclosure and presentation. Other respondents think that guidance is necessary and that the final *Practice Statement* should include a more detailed discussion on the application of materiality in the context of recognition and measurement.

19. We think that an entity applies the same judgements when applying materiality in the context of recognition and measurement as it does in the context of disclosure and presentation. When preparing Agenda Paper 11D *The Materiality Process* for the October 2016 Board meeting, we took care to describe the process in a way that would be applicable to applying materiality in the context of recognition and measurement as well as in the context of disclosure and presentation.

20. We think that a separate section on recognition and measurement in the final *Practice Statement* is unnecessary. Instead we recommend that explanation of the application of materiality in the context of recognition and measurement should be included throughout the final *Practice Statement*.

21. We note that the Exposure Draft stated that the cost of applying the requirements in IFRS Standards is not a factor for an entity to consider when assessing whether information is material because the Board takes into account the balance between costs and benefits when developing an IFRS Standard. We therefore disagree with the suggestion that materiality may be used in response to circumstances in which it may be 'extremely complicated and expensive to measure recoverable amount'.

Practical expedients

22. We observe that the ASBJ commented that the term 'practical expedient' is often used in IFRS Standards to explain that a simplified accounting treatment is permitted for cost-benefit reasons. They asked that the Board explains the difference between these and the examples of practical expedients included in the Exposure Draft that relate to internal record-keeping procedures.

23. In response to this comment we have examined each of the examples given in the Exposure Draft, and others from IFRS Standards, to consider how these compare.

Examples of practical expedients in the Exposure Draft

24. Paragraph 63 of the Exposure Draft describes a practical expedient in which an entity maintains a periodic inventory system and then later adjusts amounts for the purchases and inventory for financial reporting purposes based on a physical inventory count. This is an example of the underlying records being maintained

by an entity on one basis, and then an adjustment applied at the end of the period in order to prepare the financial statements on an IFRS Standards basis. We consider this practical expedient to be a book-keeping/cost-saving expedient, rather than a materiality expedient.

25. Paragraph 64 of the Exposure Draft describes a practical expedient in which an entity applies a policy of capitalising capital expenditures only in excess of a specified threshold and recognising smaller amounts as an expense on the grounds that those smaller amounts are 'clearly immaterial'. This is a materiality practical expedient in respect of the *recognition* of a transaction, but only for financial reporting purposes—all capital expenditures would be recognised in the underlying book-keeping. This materiality practical expedient is an example of applying an accounting policy that departs from the policy required by the applicable IFRS Standard. Such a departure is permissible provided that the effect of the departure is not material, as explained in paragraph 8 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*:

> IFRSs set out accounting policies that the IASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. These policies need not be applied when the effect of applying them is immaterial.

26. Paragraph 65 of the Exposure Draft describes a third practical expedient in which an entity selects a monetary unit, for example CU 1,000[1], and rounds figures to the nearest unit when preparing the financial statements. This is a materiality practical expedient in respect of the *presentation* of transactions, but only for financial reporting purposes—all transactions would be recognised in the underlying book-keeping to the smallest unit used in that specific currency. This materiality practical expedient is an example of the removal of immaterial information (by simplifying the number) to ensure that it does not obscure material information. This is consistent with paragraph 30A of IAS 1 *Presentation of Financial Statements*, which states:

[1] In this paper currency amounts are denominated in 'currency units' (CU).

> When applying this and other IFRSs an entity shall decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements which include the notes. An entity shall not reduce the understandability of its financial statements by obscuring material information which immaterial information or by aggregating material items that have different natures or functions.

Other examples of practical expedients

27. One respondent suggested that the application of IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* on a portfolio basis could be viewed as examples of application of materiality through practical expedients. In both Standards[2] the Board described the application of each Standard at a portfolio level as a practical expedient that, when applied with appropriate assumptions, is expected to achieve materially the same outcome as applying each Standard to the individual contracts within those portfolios. These are materiality practical expedients in respect of both *recognition and measurement* of the transactions. Both of these practical expedients are optional—an entity may choose to apply each Standard on a contract by contract basis.

28. We also searched the IFRS Standards to identify other examples of practical expedients. Among the examples we identified was one in IAS 19 *Employee Benefits* in relation to the accounting for pension plan administration costs. Paragraph BC127 of the Basis for Conclusions on IAS 19 explains that the Board decided that an entity should recognise administration costs when the administration services are provided. It explained that this practical expedient would avoid the need to attribute costs between current and past service and future service. This is a cost-benefit expedient decision taken by the Board in the development of the Standard rather than a materiality practical expedient available to an entity to choose when preparing financial statements.

29. We propose that the final *Practice Statement* includes a description of materiality practical expedients, together with examples that identify what the objective of the

[2] See paragraph 4 of IFRS 15 and paragraph B1 of IFRS 16.

materiality practical expedient is in each case, eg recognition, measurement, presentation.

30. We also propose that the description of materiality practical expedients includes a description of the discipline that the Board would expect of an entity when applying a materiality practical expedient, similar to that included in the IFRS 15 and IFRS 16 practical expedients described above. That is, an entity would be expected to use appropriate estimates and assumptions when applying a materiality practical expedient in order that it can reasonably expect that the effects on the financial statements of doing so would not differ materially from the application of the applicable IFRS requirements without the use of that expedient.

Differentiation of practical expedients and errors made intentionally to mislead

31. We are aware of concerns raised about how to differentiate between practical expedients and errors made intentionally to mislead. These concerns are considered in Agenda Paper 11A *Errors*.

Staff recommendation

32. We recommend that the Board includes guidance on the application of materiality in the context of recognition and measurement throughout the final *Practice Statement*. This is consistent with how we presented the 'Materiality Process' in Agenda Paper 11D for the October 2016 Board meeting. We note that some topics addressed in the final *Practice Statement* may have a greater emphasis on recognition and measurement than others. Examples include the application of materiality to interim reporting[3] and to errors (which is discussed in Agenda Paper 11A for this meeting). We think providing guidance on applying materiality in both a recognition and measurement context and a disclosure and presentation context on a topic by topic basis will be more helpful.

33. We recommend that the Board includes in the final *Practice Statement* a description of materiality practical expedients, together with examples that

[3] See Agenda Paper 11H *Interim reporting* discussed at the October 2016 Board meeting.

identify the objective of those expedients, eg in relation to recognition, measurement, presentation, etc. We recommend that the Board describes in the final *Practice Statement* the discipline that the entity should apply in respect of materiality practical expedients. That is, the entity should have a basis to reasonably expect that the effects on the financial statements of applying the expedients would not differ materially from not doing so.

Questions for the Board

Question 1—recognition and measurement
Do you agree that the Board includes guidance on the application of materiality in the context of recognition and measurement throughout the final *Practice Statement*?

Question 2—practical expedients
(a) Do you agree that the Board includes in the final *Practice Statement* a description of *materiality* practical expedients, together with examples that identify the objective of those expedients? (b) If yes, do you agree that the final *Practice Statement* should also describe the discipline that the entity should apply in respect of materiality practical expedients? Specifically, the entity should have a basis on which to reasonably expect that the effects on the financial statements of applying the expedients would not differ materially from not applying the expedient?