IFRS

STAFF PAPER

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IASB Meeting

Project	**Disclosure Initiative: Materiality**
Paper topic	Status and form of the guidance

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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 to confirm the *status* (ie mandatory versus non-mandatory guidance) and the *form* that the guidance on applying the concept of materiality to IFRS financial statements should take.

2. The Board proposed to provide guidance on the application of materiality in the preparation of IFRS financial statements in the form of a non-mandatory Practice Statement. A Practice Statement is not a Standard and its application is not required in order to state compliance with IFRS Standards.

Considerations presented in the Exposure Draft

3. The Board's reasoning for issuing guidance in the form of a non-mandatory Practice Statement is set out in paragraphs BC10–BC15 of the Exposure Draft.

4. The main reasons are:

   (a) mandatory guidance could create *conflicts* with national legal frameworks (paragraph BC11 of the Exposure Draft);

(b) including mandatory guidance in a Standard could risk appearing prescriptive, undermining the emphasis on management *judgement* in applying materiality (paragraph BC13 of the Exposure Draft);

(c) issuing guidance as a separate, 'stand-alone', non-mandatory document would help to emphasise that the concept of materiality is *pervasive* in IFRS Standards (paragraph BC14 of the Exposure Draft); and

(d) the Board preferred the Practice Statement over educational material because a Practice Statement is subject to *full due process*, including public consultation, and would be more *accessible* and *formal* than education material[1] (paragraph BC15 of the Exposure Draft).

Summary of the feedback

5. The Board asked for feedback on the status and form of the guidance. Question 1, in the 'Invitation to comment' section of the Exposure Draft, asked respondents:

(a) whether the guidance should be issued as non-mandatory guidance; and

(b) whether a Practice Statement is the appropriate form for non-mandatory guidance.

6. Almost all respondents replied to Question 1. Of those, the vast majority was in favour of non-mandatory guidance, while the remainder suggested mandatory guidance.

7. Among those who favoured non-mandatory guidance, there were different views on the *form* the guidance should take:

(a) the large majority was in favour of a non-mandatory Practice Statement, agreeing with the Board's reasoning in the Basis for Conclusions and welcomed the full due process (which does not apply to educational material);

[1] The development of educational material does not take place in public meetings and is not subject to the public scrutiny that is given to the development of IFRS Standards. The due process steps needed vary depending on the type of educational initiative.

(b) some other respondents suggested the guidance should take the form of non-mandatory implementation guidance accompanying either IAS 1 *Presentation of Financial Statements*, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* or The Conceptual Framework for Financial Reporting (the *Conceptual Framework*); and

(c) a few respondents suggested it might more appropriate to provide the guidance in the form of education material.

8. Those suggesting that the Board issues the guidance as a separate appendix to a Standard were concerned that a Practice Statement would not 'receive the attention it deserves' (Westworth Kemp Consultants CL5). In their view, the inclusion of the guidance in an appendix accompanying either IAS 1 or IAS 8 would give it more prominence and give it more authoritative status.

9. One such view was expressed by the European Securities and Markets Authority (ESMA):

> ESMA has concerns that by issuing this guidance in the form of a Practice Statement the IASB would de-emphasise the nature of the guidance and thus limit its visibility to constituents. Consequently, ESMA considers that the guidance should take the form of Implementation Guidance to IAS 1. (…)
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> Contrary to conclusion in paragraph BC 14 of the draft Practice Statement, ESMA is of the view that a non-mandatory guidance supporting IAS 1 would also help to emphasise that the concept of materiality is pervasive throughout IFRS and at the same time become more visible and *accessible* for constituents. (…)
>
> Furthermore, taking the form of Implementation Guidance to IAS 1, rather than a separate Practice Statement, would provide more *visibility* to this guidance and attract more attention from preparers of financial information when exercising their judgement on the application of the principle of materiality [emphasis added] (CL 26).

10. The ‘accessibility’ of the guidance was also mentioned by the Canadian Accounting Standards Board (AcSB) (‘Given the importance of the Disclosure Initiative project in improving the disclosure of relevant information, guidance issued should be as accessible as possible.’, CL44) and the Swedish Enterprise Accounting Group (SEAG) (‘From a preparer perspective, the accessibility of the guidance is of more concern than how it is formally labelled.’, CL49) in their comment letters.

11. Finally, those preferring the guidance to be issued as educational material suggested that educational material would better reflect the nature and supposed usage of the document.

12. Regarding the *status* of the guidance (mandatory versus non-mandatory), we noted a widespread support for the Board’s reasoning as outlined in the Basis for Conclusions on the Exposure Draft[2]. Preparers and users, as well as audit firms and Standard Setters, agreed with the considerations that lead the Board to propose non-mandatory guidance.

13. Respondents also acknowledged the challenges of issuing mandatory requirements:

    (a) ‘…we believe it is *extremely difficult* to mandate a particular approach to making the necessary judgements to apply the materiality concept in practice’ [emphasis added] (Grant Thornton International, CL30);

    (b) ‘We are of the opinion that the outcome of such a discussion shouldn't be in the form of a mandatory statement (…) because of the *difficulties* involved in developing such a statement of sufficient precision and generality’ [emphasis added] (Swedish Financial Reporting Board, CL91);

    (c) ‘…we believe the challenges that would be encountered in enforcing mandatory guidance on materiality are hard to overcome in practice’ (EY, CL70).

[2] See paragraphs BC10–BC15 of the Exposure Draft.

14. On the other hand, respondents calling for mandatory guidance stated that, in order to generate the behavioural change sought by the Board[3], the document should be mandatory:

> … issuing the guidance as a non-mandatory suggests it is something that management can regard or disregard as they choose, and therefore fails to create the desired tension that will lead to behavioural change (The 100 Group of Finance Directors, CL62).

15. Furthermore, in their view, mandatory guidance would:

    (a) 'allow less bias but more careful guidance and application of materiality' (Malta Institute of Accountants, CL67); and

    (b) provide management with a clearer footing in discussion with auditors and regulators and clearer requirements that might help in case of litigation:

    > IFRS Preparers could possibly take the view that since it is non-mandatory, they are not obliged to adhere to the guidance. In such situation, the auditor would not be able to fall back on the Practice Statement since it is non-mandatory. Additionally, though non-mandatory, in the event of litigation it might be argued that a Practice Statement represents best practice and is expected to be followed (The Malaysian Institute of Certified Public Accountants, CL9).

Staff analysis and recommendation

16. The Board preliminarily discussed the status and form the guidance on materiality should take at its November 2014 meeting[4]. Three different options were considered: mandatory application guidance, education material or a Practice Statement.

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[3] The Board noted that 'if management is given guidance to refer to, they may feel more confident in exercising judgement when applying the concept of materiality. Consequently, the issuance of guidance may promote a change in behaviour.' (paragraph BC7 of the Exposure Draft).

[4] Refer to Agenda Paper 11C *Materiality* presented to the Board in November 2014.

17. At that time, the staff recommended the Board to include guidance on application of materiality in a Practice Statement and to ask constituents for feedback on that option. The Board agreed with the staff recommendation.

Status of the guidance

18. The feedback received from the exposure of the Practice Statement indicated widespread agreement with the considerations that lead the Board to propose non-mandatory guidance, namely:

    (a) the risk of creating *conflicts* with national legal frameworks; and

    (b) the risk of appearing too prescriptive, undermining the emphasis on management judgement in the application of materiality.

19. We acknowledge that issuing mandatory guidance might promote greater consistency, but we still believe, in the light of the comments received, that non-mandatory guidance best suits the objectives of the Materiality project.

20. If well publicised, non-mandatory guidance would promote positive changes in behaviour (such as discouraging rigid adherence to checklists when preparing the financial statements) and encourage management to exercise judgement to a greater extent (which were part of the Board's objectives for undertaking the Materiality project).

21. Moreover we believe that the effectiveness of the guidance is more related to the way it is structured and drafted than to its *status*. The more understandable and operational the guidance is, the more the Board's objectives are likely to be met.

22. Finally, as highlighted in the Basis for Conclusions on the Exposure Draft, the final guidance does not change any existing requirements in IFRS Standards nor introduce any new requirements. Hence a non-mandatory status would be more appropriate in our opinion.

23. We therefore recommend that the Board confirms the non-mandatory *status* of its guidance on applying materiality in the preparation of IFRS financial statements.

Form of the guidance

24. Regarding the *form* of the guidance, we still believe, in the light of the comments received, that a Practice Statement is the alternative with the greater advantages and fewer disadvantages.

25. A Practice Statement is a *formal* document, subject to the *full due process*, but with more *flexibility* than a Standard in terms of the content and possibility to introduce explanatory language and examples. We also believe that its stand-alone nature would emphasise more than other alternatives that the concept of materiality is *pervasive* in the IFRS Standards.

26. Some respondents stated that similar outcomes, at least in terms of *formality* and *flexibility* of the guidance, could be achieved by opting for non-mandatory application guidance accompanying IAS 1 (or IAS 8). We acknowledge that this could be achieved by issuing a new non-mandatory appendix to IAS 1 (or IAS 8), thereby retaining the advantages of a self-contained document. However due to the pervasiveness of the materiality concept, we suggest that the Board does not attach the guidance to a specific Standard. The content of the guidance on materiality does not exclusively relate to requirements outlined in IAS 1 (or IAS 8).

27. Some respondents were concerned about the accessibility of the guidance. The IFRS Practice Statement: *Management Commentary*, which is the only Practice Statement issued so far, is freely available on the IFRS Foundation website. If the final IFRS Practice Statement on materiality is also made freely available, this will help the accessibility of the guidance. This contrasts with the non-mandatory appendices to the IFRS Standards that are not freely available—a paid subscription is required to access those.

28. The IFRS Practice Statement: *Management Commentary* is placed at the end of the Red Book, part B, just before the IFRS Foundation Constitution. Some have suggested that a similar placement would not give the final Practice Statement on materiality sufficient prominence. We think that the visibility of the guidance might be addressed by choosing an alternative location within the bound volume (eg in the Red Book, part A, right after the *Conceptual Framework*).

29. We recommend that the Board confirms its decision to issue the guidance on materiality in the form of a Practice Statement. A Practice Statement is the *form* that combines greater advantages and fewer disadvantages compared to other alternatives.

Question for the Board

Question 1—status and form of the guidance
(a) Do you agree that the Board should finalise the guidance on applying materiality in the preparation of IFRS financial statements as non-mandatory guidance? (b) If yes, do you agree that the guidance should be issued in the form of an IFRS Practice Statement?