

Draft Comment Letter

Comments should be submitted by 15 February 2016 to
commentletters@efrag.org

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH, United Kingdom
[Date]
Dear Mr Hoogervorst,

Re: Exposure Draft ED/2015/8 IFRS Practice Statement: *Application of Materiality to Financial Statements*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2015/8 IFRS Practice Statement: *Application of Materiality to Financial Statements*, issued on 28 October 2015 (the 'draft Practice Statement').

This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would have been reached in its capacity of advising the European Commission on endorsement were the draft Practice Statement to result in material falling within the scope of the EU's IAS Regulation.

EFRAG welcomes the issue of application guidance on materiality in the non-mandatory form of a practice statement. EFRAG considers that such guidance could be helpful, in particular in the context of disclosures, in order to provide a common ground for applying judgement in deciding which information is relevant for users and fostering thinking on how materiality is applied. Accordingly, EFRAG considers that such guidance can be useful without waiting for the completion of the IASB's Principles of Disclosure project.

However, EFRAG considers that the objectives of the guidance should be clarified to state that the Practice Statement could be useful beyond application by preparers, as it should also promote a common understanding of the role and application of materiality in IFRS. Furthermore, EFRAG considers that the guidance should be drafted in a more concise and practical way and focus on areas where it is most difficult to exercise judgement on the application of materiality and, in particular, better illustrate how materiality is applied in line with the specific roles of the primary financial statements and of the notes. The inclusion of illustrative examples may be useful if they illustrate both decisions to include and to leave out information.

EFRAG's detailed comments and responses to the questions in the draft Practice Statement are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Hocine Kebli, Giorgio Acunzo, Vincent van Caloen or me.

Yours sincerely,
Roger Marshall

Acting President of the EFRAG Board

APPENDIX

General comments

- 1 EFRAG welcomes the IASB's initiative to provide additional guidance on the application of materiality because it could be helpful, in particular in the context of disclosures, to provide a common ground for applying judgement in deciding which information is relevant for users and to foster thinking on how materiality is applied and is to be understood. We believe that if preparers are given guidance to refer to, they may feel more confident in exercising judgement when applying the concept of materiality.
- 2 However, EFRAG considers that the objective set out in paragraph 1 of the draft Practice Statement is too restrictive because it defines its purpose as being to '*assist management in applying the concept of materiality to general purpose financial statements*'. EFRAG agrees that the primary objective of the guidance in the draft Practice Statement is to foster the exercise of judgement by preparers in applying the concept of materiality to general purpose financial statements prepared under IFRS. However, consistent with the discussion in paragraphs BC10 and BC17 of the Basis for Conclusions of the draft Practice Statement, EFRAG believes that the draft Practice Statement should also aim at promoting a greater understanding of the role of materiality in IFRS by all those involved in the issue or use of financial statements and at encouraging a more effective dialogue about materiality.

Form of the guidance

Question 1—Form of the guidance

A Practice Statement is not a Standard. The IASB's reasoning for issuing guidance on applying the concept of materiality in the financial statements in the form of a non-mandatory Practice Statement is set out in paragraphs BC10-BC15.

- (a) Do you think that the guidance should be issued as non-mandatory guidance? Why or why not?
- (b) Do you think that a Practice Statement is the appropriate form for non-mandatory guidance on applying the concept of materiality? Why or why not? If not, what alternative(s) do you propose and why?

Notes to constituents

- 3 *The draft Practice Statement states in its Basis for Conclusions that the IASB proposes to provide guidance on the application of materiality in the form of a non-mandatory Practice Statement, rather than as mandatory guidance in a Standard because of the following concerns:*
 - (a) *potential conflicts with national legal frameworks; and*
 - (b) *the risk of appearing prescriptive, which could undermine the emphasis on management applying their judgement in the application of materiality.*
- 4 *The IASB also observes that issuing guidance as a separate non-mandatory document, rather than as non-mandatory implementation guidance supporting a specific Standard, such as IAS 1 Presentation of Financial Statements, would help to emphasise that the concept of materiality is pervasive throughout IFRS.*
- 5 *Finally, the IASB acknowledges that a Practice Statement is preferable to educational material for the following reasons:*

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- (a) *the draft Practice Statement would constitute a formal document that a jurisdiction could choose to mandate;*
- (b) *it will be subject to full due process, including public consultation allowing the IASB to obtain input from a wide range of stakeholders on the proposed content of the draft Practice Statement; and*
- (c) *it will be more accessible and formal than educational material as it becomes part of the IFRS Bound Volume (part B of the Red Book).*

EFRAG's response

EFRAG supports the issue of non-mandatory guidance in the form of a practice statement.

- 6 EFRAG supports the issue of non-mandatory guidance on materiality in the form of a practice statement. In arriving at this conclusion, EFRAG has considered the following:
- (a) The concept of materiality is pervasive in IFRS and therefore the guidance on its application should not be attached to a specific standard such as IAS 1 *Presentation of Financial Statements* or its replacement standard.
 - (b) Although we acknowledge that a practice statement is an unusual form of guidance that may attract less attention from preparers, we believe that the essence of the proposed guidance is to foster the exercise of judgement on the application of the principle of materiality, which is itself a mandatory principle in IFRS.
 - (c) Guidance that is mandatory could be difficult to enforce in certain jurisdictions and could possibly result in conflicts with other applicable regulations.
- 7 EFRAG also considered, in forming its view, the fact that the draft Practice Statement will be subject to the IASB's due process and consultation equivalent to that of a Standard and will be given visibility, if issued, by becoming part of the IFRS Bound Volume (volume B of the Red Book).
- 8 Lastly EFRAG observed that, as mentioned in paragraph BC13 of the Basis for Conclusion of the draft Practice Statement, jurisdictions could choose to mandate the guidance into their national framework if they wish to do so. Having said that, EFRAG believes that the guidance should remain non-mandatory in Europe.

Question to Constituents:

- 9 Do you agree that the guidance should be issued in the non-mandatory form of a practice statement? If not, please explain your preferred form. If so, please explain how you believe a non-mandatory practice statement may result in positive changes in behaviour.
- 10 Do you consider that specific aspects of the proposed content of the guidance may cause enforcement issues or conflict with local regulations? Please specify which aspect, if any.

Illustrative examples

Question 2—Illustrative examples

Do you find the examples helpful in the [draft] Practice Statement? Do you think any additional practical examples should be included? If so, what scenarios should the examples address? Please be as specific as possible and explain why those example(s) would be helpful to entities.

Notes to constituents

- 11 *The draft Practice Statement does not include a separate section with Illustrative Examples, but includes examples throughout the document:*
- (a) *in the ‘General Characteristics of Materiality’ section, examples are primarily given of cases where quantitative aspects may not be helpful in assessing materiality;*
 - (b) *in the ‘Presentation and Disclosure in the Financial Statements’ section, examples are primarily given of judgements about whether to aggregate information, either in the primary financial statements or in the notes and whether disclosures required by specific standards could reasonably be expected to influence decisions that the primary users make on the basis of the financial statements;*
 - (c) *the ‘Recognition and Measurement’ section focusses on practical expedients; and*
 - (d) *in the ‘Omissions and Misstatements’ section, examples are primarily given of situations in which management may identify that it has misstated information in the entity’s financial statements.*

EFRAG’s response

EFRAG considers that examples can be useful to illustrate the way judgement on materiality is exercised. However, examples should illustrate both decisions to include and to leave out information and focus on those areas where judgement is the most difficult to exercise.

- 12 EFRAG considers that the use of illustrative examples can be helpful to make the guidance more practical and, in particular, to illustrate the way judgement is exercised and the decision process inherent to the assessment of materiality, which is necessary in deciding whether to include or exclude an information and which prominence it should be given.
- 13 However, after considering the examples currently included in the draft Practice Statement, EFRAG believes that they should be improved so as to:
- (a) illustrate both decisions to include or to omit information from the financial statements and not over-emphasise the first aspect; and
 - (b) focus on those areas where judgement is assessed to be the most difficult to exercise.
- 14 In its response to Question 3 on the proposed content of the Practice Statement, EFRAG identifies several areas where judgement is considered difficult (see paragraph 25, below). As a result, EFRAG recommends that the illustrative examples should, to the extent possible, address these topics as a priority.

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- 15 Lastly, EFRAG also considers that the examples should be carefully drafted so as to not unintentionally extend the scope of the guidance to information outside the financial statements. For instance:
- (a) paragraph 22 of the draft Practice Statement, in suggesting that an entity should consider how users '*think the entity should be managed*'; and
 - (b) paragraph 28(a) of the draft Practice Statement, in suggesting that an entity considers items '*that could trigger non-compliance with regulatory requirements*'.
- 16 We believe that the drafting of these examples should be clarified to better explain their application within the boundaries of the financial statements.

Question to Constituents:

- 17 Do you agree that the inclusion of illustrative examples in the Practice Statement is helpful? If not, please explain.
- 18 Do you agree with EFRAG's assessment that illustrative examples should focus on the areas discussed in Paragraph 13 above?
- 19 Do you believe that the illustrative examples currently included in the draft Practice Statement could have any unintended consequences or counter-productive effects? If so, please explain.

Content of the draft Practice Statement

Question 3—Content of the [draft] Practice Statement

The [draft] Practice Statement aims to propose guidance in three main areas:

- (a) characteristics of materiality;
- (b) how to apply the concept of materiality in practice when presenting and disclosing information in the financial statements; and
- (c) how to assess whether omissions and misstatements of information are material to the financial statements.

It also contains a short section on applying materiality when applying recognition and measurement requirements.

Please comment on the following and provide any suggestions you have for improving the [draft] Practice Statement:

- (a) Do you think that any additional content should be included in the Practice Statement? If so, what additional content should be included and why?
- (b) Do you think the guidance will be understandable by, and helpful to, preparers of financial statements who have a reasonable level of business/accounting knowledge and IFRS? If not, which paragraphs/sections are unclear or unhelpful and why?
- (c) Are there any paragraphs/sections with which you do not agree? If so, which paragraphs/sections are they and why?
- (d) Do you think any paragraphs/sections are unnecessary? If so, which paragraphs/sections are they and why?
- (e) Do you think any aspects of the guidance will conflict with any legal requirements related to materiality within your jurisdiction, or a jurisdiction in which you file financial statements?

Notes to constituents

20 *The proposed content of the draft Practice Statement is summarised in the first two paragraphs of the question above. The draft Practice Statement also provides guidance on the following topics:*

- (a) *The context of the materiality assessment.*
- (b) *Qualitative and quantitative assessment.*
- (c) *Immaterial information.*
- (d) *Aggregating and disaggregating information.*
- (e) *Primary financial statements versus the notes; which also covers:*
 - (i) *Disclosures specified in IFRS;*
 - (ii) *Reviewing note disclosures at each reporting date;*
 - (iii) *Complete set of financial statements; and*
 - (iv) *Interim reporting.*
- (f) *Recognition and measurement with reference to practical expedients.*
- (g) *Omissions and misstatements, which also covers:*

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- (i) *Identified misstatements;*
- (ii) *Current period misstatements;*
- (iii) *Prior period errors; and*
- (iv) *Misstatements made intentionally to mislead.*

21 *The draft Practice Statement does not include a separate section with Illustrative Examples, but includes examples throughout the document including disclosures of significant accounting policies, and disclosures required by IFRS 8 Operating Segments.*

EFRAG's response

EFRAG considers that the draft Practice Statement should be drafted in a more concise and practical way and focus on the key steps of the process necessary to make decisions and exercise judgement on materiality. In particular, EFRAG recommends that the IASB better illustrate how the assessments on materiality is applied in line with the specific roles of the primary financial statements and of the notes.

22 EFRAG considers that, to be helpful and meet its intended objectives, the guidance should be drafted in a more concise and practical way as explained below.

Structure of the guidance

23 EFRAG believes that the guidance will be more useful if it is structured along the key steps of the process inherent in decisions on materiality. EFRAG has identified four major steps that could be a basis for structuring the guidance:

- (a) understand what information is useful for users for their decision making;
- (b) assess which information required by Standards should be included and which can be left out in the specific context of the entity;
- (c) assess which additional information, not specifically required by a Standard, would be useful in the specific context of the entity, and
- (d) consider what can be aggregated to arrive at an appropriate level of materiality.

24 EFRAG notes that many paragraphs of the draft Practice Statement merely quote or reproduce in full guidance that is contained in the existing IFRS literature. We believe that, to facilitate the reading, the quotes and references to the existing IFRS literature could be moved into an appendix and referred to by cross-references only.

Content of the guidance

25 EFRAG considers that the draft Practice Statement should primarily aim at providing guidance on areas where existing difficulties, reluctance or inability to use an appropriate level of judgement in applying the concept of materiality have been identified. We identify the following areas that we consider to be the primary focus for guidance on applying materiality:

- (a) the qualitative aspect of materiality rather than the quantitative one, which is generally better understood;
- (b) the application of materiality to disclosures (which require a greater level of judgement) rather than the aggregation/ disaggregation on the face of the primary financial statements;

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- (c) how materiality applies in the determination of the prominence to be given to information (should information be presented on the face of the primary financial, separately or in aggregation, in the notes or in both?);
- (d) how the consideration of stewardship affects materiality;
- (e) how materiality is applied in interim financial reporting;
- (f) how the concept of 'obscuring' material information with immaterial information applies; and
- (g) the application of materiality in relation to significant assumptions, estimates and uncertainties.

26 EFRAG further discusses some of the topics above, in the following paragraphs.

Materiality and prominence of information

27 Judgements on materiality are not only about whether to disclose or not disclose information but also about giving prominence to information. When preparing financial statements, an entity has to decide whether it will:

- (a) present an item separately in its primary financial statements; or
- (b) aggregate it with others; and/or
- (c) provide disclosures in the notes.

28 This raises the question of how the single definition of materiality applies to the different components of the financial statements.

29 The draft Practice Statement, in paragraph 46, indicates that the application of materiality to the primary financial statements and the notes should reflect their different roles in achieving the overall objective of financial statements. The draft Practice Statement also states that the concept of materiality does not change when applied to the notes, *'the context in which that concept is applied is different because the notes have a different role from the primary financial statements in meeting the objective of financial statements'*.

30 EFRAG doubts that the mere reference to the different roles of the primary financial statements and the notes provides sufficient guidance. The reference also pre-empts the outcome of any discussion about the definitions and the respective roles of the 'primary financial statements' and the notes that is expected to be part of the *Principles of Disclosure* Discussion Paper (see response to Question 4 – Timing).

31 Therefore, EFRAG recommends that the IASB articulate how the respective assessments are made. One important aspect concerning materiality for disclosures is whether there should be a separate assessment of (i) the materiality of an item and (ii) the materiality of each piece of information about a material item. For example, in EFRAG's view, if an entity has a material pension liability, it does not automatically imply that all the related disclosure requirements about that liability are material.

32 The IASB could consider some form of decision tree to illustrate how preparers should apply their judgement in deciding whether (a) an item is material; (b) which pieces of information about that item are material; and (c) how to deal with omissions and misstatements relating to items that are not material. The decision tree could illustrate how the existing definition of materiality applies to the different levels of the assessment:

- (a) information or line items that are individually material and warrant separate presentation either in the primary financial statements or in the notes;

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- (b) information or line items that are not individually material, and can be aggregated with other items either in the primary financial statements or in the notes; and
- (c) information or lines item that are not sufficiently material to warrant separate presentation in the primary financial statements, may warrant separate presentation in the notes.

Materiality and the assessment of stewardship

- 33 The objective of financial statements refers to both the usefulness of the information for users' decision-making and to the assessment of stewardship.
- 34 Although some references to the stewardship objective are included in the draft Practice Statement, the guidance and illustrative examples contained in the draft Practice Statement essentially refer to the first objective.
- 35 EFRAG therefore believes it is unclear which of the objectives should prevail or whether the entity should always consider the lowest common denominator that achieves both objectives.

Materiality and interim financial reporting

- 36 EFRAG understands that applying materiality in interim financial reporting is sometimes controversial given the way users are understood to project materiality on yearly results. Paragraph 23 of IAS 34 *Interim Financial Reporting* also acknowledges that '*in making assessments of materiality (...) interim measurements may rely on estimates to a greater extent than measurements of annual financial data*'.
- 37 Accordingly, EFRAG supports the IASB's decision to address this area in the draft Practice Statement. However, EFRAG notes that the draft Practice Statement only reproduces guidance in IAS 34 *Interim Financial Reporting*. Therefore, EFRAG recommends that the IASB describe the typical hurdles preparers encounter in applying materiality to interim financial reporting and provide clarifications, possibly through illustrative examples.
- 38 The draft Practice Statement could illustrate how the 'greater reliance on estimates', in interim reporting, referred to above, affects the application of materiality and how materiality is to be assessed in relation to the interim period financial data and not forecast annual data.

Obscuring material information

- 39 Paragraphs 34 to 36 of the draft Practice Statement discuss the notion of 'immaterial information'. However the guidance only refers to two dimensions of the issue, namely:
 - (a) the potential obscuring of material information with immaterial information; and
 - (b) the need, in some instances, to disclose immaterial information (for instance the absence of material exposure to certain risks).
- 40 The guidance does not address comprehensively the issue of immaterial information in the financial statements. We believe that the draft Practice Statement should provide guidance on when information is considered immaterial and how to deal with it.
- 41 EFRAG also believes that the reference to 'obscuring information' would need to be clarified in the final Practice Statement as it could be interpreted differently. This is particularly relevant to the European context where the notion of 'obscuring'

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information is absent from the definition of materiality contained in the 2013 Accounting Directive.

Materiality and disclosures on assumptions, estimates and uncertainties

- 42 EFRAG believes that the areas for which the application of materiality is difficult and could be clarified in the Practice Statement include the requirements on judgement and assumptions contained in:
- (a) paragraph 122 of IAS 1 which requires the disclosure of significant judgements made in applying the entity's accounting policies; and
 - (b) paragraph 125 of IAS 1, which requires the disclosure of assumptions about the future and other major sources of estimation uncertainty that have a significant risk of causing material adjustments in the next financial year.
- 43 The need for guidance arises because:
- (a) the accounting for some items requires the use of best estimates, fair values and allocations of costs and revenues to different activities and periods. Sometimes entities need to apply practical expedients to determine these values; and
 - (b) in considering the materiality of uncertainties and contingencies, preparers have to make estimates of the potential monetary amounts involved, taking into account the likelihood of occurrence, because this may affect their assessment.

Question to Constituents

- 44 Do you agree that the draft Practice Statement should primarily provide guidance on the topics identified in paragraphs 25 to 43? If not, please explain which other topics should be covered.

Timing

Question 4—Timing

The IASB plans to issue the draft Practice Statement before the finalisation of its Principles of Disclosure project.

The IASB has tentatively decided to include a discussion on the definition of materiality, and whether there is a need to change or clarify that definition within IFRS, in the Discussion Paper for its Principles of Disclosure project (expected to be issued early next year). Nevertheless, the IASB thinks that to address the need for guidance on the application of materiality, it is useful to develop the draft Practice Statement now, rather than wait until the Principles of Disclosure project has been finalised.

The IASB does not envisage that the discussion about the definition of materiality or any other topics in its Principles of Disclosure project will significantly affect the content of the draft Practice Statement. Nevertheless, the IASB will make any consequential amendments to the draft Practice Statement as necessary following the completion of the Principles of Disclosure project. Do you agree with this approach?

Notes to constituents

- 45 *Paragraphs 22 and 23 of the Basis for Conclusions explains that, although it has tentatively decided to include a discussion on the definition of materiality in its forthcoming Discussion Paper for its Principles of Disclosure project, the IASB thinks*

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that it is useful to develop guidance on the application of materiality now, rather than wait until the Principles of Disclosure project has been finished, to address requests for guidance. Furthermore, the IASB 'does not envisage that the discussion about the definition will significantly affect the general content of the draft Practice Statement'.

- 46 *Regarding the guidance on the role of the primary financial statements and the role of the notes described in paragraphs 41, 45 and 47 of the draft Practice Statement, the IASB acknowledges that it is based on its current proposals in its Principles of Disclosure project but notes that it intends to update the content of the draft Practice Statement, as necessary, following completion of its Principles of Disclosure and Conceptual Framework projects.*

EFRAG's response

EFRAG supports the IASB's decision to issue the draft Practice Statement before the finalisation of its Principles of Disclosure. However, EFRAG recommends that the IASB closely monitor the outcome of the Principles of Disclosure and other ongoing projects (such as the Conceptual Framework) to ensure that the Practice Statement is updated on a timely basis, if needed.

- 47 EFRAG supports the IASB's decision to issue the draft Practice Statement before the finalisation of its Principles of Disclosure.
- 48 We believe that the application guidance on materiality contained in the draft Practice Statement has merit under the existing disclosure requirements in IFRS, and waiting for the completion of the Principles of Disclosure project, which is only about to enter into its discussion paper stage, would unduly delay the provision of useful guidance.
- 49 However, EFRAG recommends that the IASB closely monitor the outcome of the Principles of Disclosure and other ongoing projects (such as the Conceptual Framework) to ensure that the Practice Statement is updated on a timely basis, if needed.

Any other comments

Question 5—Any other comments

Do you have any other comments on the [draft] Practice Statement? As mentioned in Question 4, a discussion about the definition of materiality will be included in the Discussion Paper in the Principles of Disclosure project, so the IASB is not asking for comments on the definition at this time.

EFRAG's response

EFRAG does not have any other comments.

- 50 EFRAG does not have any other comments.

Question to Constituents:

- 51 Do you have any other comments on the draft Practice Statement or on EFRAG's draft comment letter?