



| | | | |
|--------------------|--|--------------------------|-------------------------------------|
| Project: | Disclosure Initiative -- Materiality Practice Statement | Meeting | AASB February 2016 (M150) |
| Topic: | Feedback from other outreach activity | Agenda Item: | 17.3 |
| Contact(s): | Ahmad Hamidi ahamidi@asb.gov.au (03) 9617 7643 | Date: | 9 February 2016 |
| | | Project Priority: | High |
| | | Decision-Making: | High |
| | | Project Status: | Form Board views on ED proposals |

Introduction

- 1 The paper summarises the feedback received from the AASB Disclosure Initiative Advisory Panel and from targeted outreach activity conducted.
- 2 This paper is set out as follows:
 - (a) Appendix 1: Feedback from targeted outreach on ED 271. Staff conducted targeted outreach, in the main with practitioners with Small-Medium Enterprises (SME) clients and those undertaking due diligence engagements; and
 - (b) Appendix 2: Feedback from AASB Disclosure Initiative Advisory Panel.
- 3 Staff considered the feedback received in developing the draft submission included as Agenda Paper 17.1.

APPENDIX 1: Feedback from targeted outreach on ED 271

Outreach with SME practitioners

- 4 Staff conducted targeted outreach with two practitioners in large and medium-sized accountancy firms with SMEs as clients, and received informal feedback from a professional body. The SMEs operated in both the for-profit and not-for-profit (NFP) sectors.
- 5 The staff summary of their feedback is included in the table below:

| Topic | Comment |
|---|--|
| Question 1-- Form of the guidance | <p><u>Involvement of management</u></p> <p>One practitioner with NFP clients noted that the assumption that management makes judgements about materiality might not hold for SMEs as the practitioner often makes that judgement on behalf of management, and that the materiality discussion between auditors and client are generally limited to sensitive issues. Another practitioner considered that generally management makes the materiality judgements; involving the practitioner only in grey areas where judgment is not easy.</p> <p><u>Definitive and practical guidance</u></p> <p>One practitioner noted the draft Practice Statement is principle-based and in that respect is a good document. However, it does not provide actual practical guidance. For SMEs, practical guidance matters. They want some quantitative thresholds for materiality such as the 5%-10% thresholds previously included in AASB 1031 <i>Materiality</i>. This participant opined that there is a need for the Practice Statement to include an Appendix with practical guidance which would include additional examples.</p> |
| Question 2-- Illustrative examples | <p>One practitioner with NFP clients noted an example in relation to the reconciliation of Property, Plant and Equipment where disclosure should not be required, for reasons of materiality. The practitioner considered that when a building is mostly depreciated and there are few additions or disposals during the prior year or the current year, there is no need for a reconciliation disclosure, given that depreciation expense is already separately disclosed.</p> <p>A respondent also suggested that it would be useful for the practice statement to give more examples of what de-cluttered disclosure would look like, for example, the accounting policy notes under paragraph 117 of AASB 101 <i>Presentation of Financial Statements</i>, and the issued but not yet effective disclosure specified by paragraph 30 of AASB 108 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>.</p> |

| Topic | Comment |
|---|---|
| <p>Question 3 -- Content of the [draft] Practice Statement</p> | <p>Participants in the outreach considered related party transactions to generally be material in the context of SMEs. Other sensitive issues from a user’s perspective are the dollar value of CEO salary and administration fees. Covenant breach is another material event particularly in a SME context.</p> <p>One participant noted that in the case of closely owned SMEs where there are, say one executive director and several non-executive directors, the non-executive directors who do not have access to internal management accounts, are interested in disclosure of information on related party transactions in financial statements.</p> <p>One practitioner with NFP clients noted that information about an entity’s results when they fall outside ‘normal’ ranges is generally considered to be material from a user perspective. When results are on breakeven point user is expected to take this as evidence that the entity is using revenue for intended expenses. If the results materially fall below breakeven point the user is expected to question whether the entity is operating efficiently. On the other hand, if there is a material surplus the question arises whether the entity is keeping the funds and not spending them on intended purposes.</p> <p>Another practitioner with for-profit SMEs as clients noted that for non-listed entities, compliance with ‘budget’ is important. Management of subsidiaries of foreign companies pay special significance to budget and specific internal benchmarks. Subsidiaries individually might not be material to the global group. However, if marketing expenses for a subsidiary is set at 3% of revenue and the entity spends 5% of its revenue on marketing, then this is generally regarded as being material information from the parent entity’s perspective.</p> <p><u>Conflict with legal requirements</u></p> <p>Accounting and Auditing Standards are legal instruments in Australia and compliance with them is required under the <i>Corporations Act 2001</i>.</p> <p>AUASB staff expect that any significant concern relating to materiality as described in the auditing and accounting standards are likely to have been considered by the IAASB and IASB before these proposals are finalised.</p> |
| <p>Question 4—Timing</p> | <p>No view was expressed on timing of publication of the Practice Statement.</p> |
| <p>Question 5—Any other comments</p> | <p>One participant commented that de-cluttering is of interest to SMEs if it is of a permanent nature. However, if a disclosure is likely to be included or excluded intermittently, generally an SME would prefer</p> |

| Topic | Comment |
|--|---|
| | <p>to retain the disclosure regardless of its materiality to the financial statements.</p> <p>Another participant, however, noted that de-cluttering for SMEs is not an important exercise as many prepare special purpose financial statements or Tier 2 general purpose financial statements.</p> |
| Australian specific matters for comment | <p>One practitioner with NFP clients queried whether the AASB would introduce Aus paragraphs for NFPs in the Materiality guidance. It was also noted that users in the NFP space are not well defined.</p> <p>Outreach with staff of Accounting Professional and Ethical Standards Board (APESB) indicated that there might be implications for Due Diligence Committees formed under <i>Corporations Act 2001</i> if the Materiality Practice Statement is issued as non-mandatory guidance and if quantitative materiality criteria are not included in the guidance.</p> |

Outreach on Implications for Due Diligence Committees (DDC)

- 6 Having regard to the concern raised by APESB staff, AASB staff conducted outreach with practitioners performing due diligence activities to better understand the potential concern. Staff understand the potential concern relates to the relationship between the form and content of the Practice Statement, and the ‘Materiality Letter’ under which a due diligence engagement is performed in accordance with [APES 350 Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document](#).
- 7 The ‘Materiality Letter’¹ sets out the quantitative matters to be considered in a due diligence engagement and presently references the concept of materiality in AASB 101 *Presentation of Financial Statements* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. The pro forma Materiality Letter uses the quantitative criteria in superseded AASB 1031 *Materiality*. With withdrawal of AASB 1031 in 2014, the same thresholds continue to be included in the Materiality Letter, although the reference to AASB 1031 is omitted.
- 8 Key themes from the feedback received in staff outreach are as follows:
 - (a) Some participants were of the view that the issuance of Materiality Practice Statement would probably not affect the Materiality Letter. DDCs would continue to look for some quantitative guidance and Lawyers prefer quantitative guidance for consistency in defending contents of public documents in courts. Thus inclusion of 5%-10% quantitative thresholds in Materiality Letters would probably continue on the basis of historical practice.

1 A Pro Forma Materiality Letter is included in APES 350.

- (b) Other participants commented that the Materiality Practice Statement is intended for preparers to make materiality judgements in relation to general purpose financial statements (GPFS). However, APES 350 applies to materiality in the context of DDCs. The users of GPFS are different from the users of public document in respect of which due diligence takes place. With context and users different, it seems Materiality Practice Statement should not have significant implications for materiality issues under APES 350.

Some participants, however, noted that the issuance of a non-mandatory AASB Practice Statement on Materiality would need to be taken into account in redrafting the pro forma Materiality Letter attached to APES 350.

- (c) Some practitioners were concerned that if quantitative criteria in Materiality Letter are decided individually by different Members in Practice, it would potentially lead to inconsistencies in issuing these letters. They noted coordination between professionals would reduce this risk but some definitive guidance would help alleviate this concern.

Staff view

- 9 Staff note that ED 271 paragraphs 4 and 5 discuss the different contexts other than financial reporting where materiality concept is used. These include legal agreements and obligations to disclose information under stock exchange rules. Paragraph 6 notes that the way in which the term materiality is understood in these different contexts is expected to be consistent with the way in which the term is expected to be applied to financial reporting.
- 10 The Basis for Conclusions paragraph BC16 notes that management might find some of the guidance in the Practice Statement helpful when making judgements about materiality for other financial reporting purposes such as preparing other parts of the financial report such as management commentary or corporate governance disclosures or when preparing regulatory filings or press releases. However, the IASB notes the Practice Statement is not designed to cover these other purposes because different considerations may apply because of the different objectives for preparing the information.
- 11 Staff are of the view that the use of a forthcoming AASB Practice Statement on Materiality for purposes such as the work of Due Diligence Committees is subject to above considerations. Thus, inclusion of any references to the Practice Statement in APESs and the pro forma Materiality Letter is a matter for APESB decision.
- 12 Accordingly, staff are of the view that the content and status of AASB Practice Statement on Materiality would not be affected by uses that would be made of the guidance in contexts other than preparation of general purpose financial statements.

Appendix 2: Summary of Disclosure Initiative Advisory Panel Comments (8 December 2015, Teleconference)

Meeting objective: Discuss ED 271 *IFRS Practice Statement: Application of Materiality to Financial Statements* (issued October 2015)

Link to ED 271: http://www.aasb.gov.au/admin/file/content105/c9/ACCED271_10-15.pdf

(a) Questions from IASB ED on [draft] Practice Statement

| Question 1—Form of the guidance(a) | Panel member comments |
|--|--|
| <p>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.</p> <p>(a) Do you think that the guidance should be issued as non-mandatory guidance? Why or why not?</p> <p>(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?</p> | <p>Panel members agreed with the form of the guidance as a Practice Statement (PS), and that the PS, when finalised, should be issued as non-mandatory guidance in Australia. Panel members gave the following reasons in support of this position:</p> <ol style="list-style-type: none"> 1. If prescriptive it would be difficult to make judgements. 2. Application of materiality should involve judgement. If the guidance were mandatory, this could result in inappropriate disclosures in the long-run as management might use it as a rule of thumb rather than as a guide for exercise of judgement. 3. Mandatory guidance would make application of judgement difficult and would lead to a ‘tick the box approach’. 4. Principles set out in the PS apply regardless of whether the PS is mandatory or not. However, if finalised as mandatory guidance, the less sophisticated preparers might look for prescriptive guidance that is not there. 5. Little would be achieved if the guidance in the PS were to be finalised as mandatory guidance as the present text includes a lot of replication of material from IFRS and the Conceptual Framework. 6. The way the PS is written does not lend itself to being finalised as mandatory guidance. <p>Members also made the following comments:</p> <ol style="list-style-type: none"> 1. A member suggested that core principles from the PS could be extracted for inclusion in a |

| Question 1—Form of the guidance(a) | Panel member comments |
|------------------------------------|--|
| | <p>Standard.</p> <ol style="list-style-type: none"> 2. A member was concerned that the guidance does not have enough prominence in its current form and queried whether it should be given prominence in some way. 3. The PS could be issued as mandatory or non-mandatory guidance as long as the guidance is principle-based. If the guidance is not principle-based or is focussed on quantitative criteria, making it mandatory could direct preparers down a route that is not desirable. |

| Question 2—Illustrative examples | Panel member comments |
|---|--|
| <p>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.</p> | <p>Panel members generally found the included examples helpful, and did not suggest any specific further examples for inclusion. However, Panel members differed in views as to whether further examples should be included. The following points were made:</p> <ol style="list-style-type: none"> 1. There should be a balance between including further specific examples and guidance being included to bring life to any underlying principles. 2. Judgement calls are subjective and more guidance/examples would help preparers make those judgement calls. For example, it would be helpful if it were clear whether macro/topical events such as the global financial crisis should affect management’s assessment of the materiality or otherwise of a transaction/balance. 3. The PS sets out principles about making judgement and examples give preparers a feel of how to make the judgement. No more examples are required but more guidance and elucidation of principles would help preparers in making judgements with confidence. 4. Do not encourage the inclusion of prescriptive examples as this would hinder the application of judgement. 5. Examples and guidelines that have quantitative criteria should not be included in the PS. We should rely on qualitative aspect and find out how it plays in practice. |

| | |
|---|---|
| Question 2—Illustrative examples | Panel member comments |
| | <p>Panel members also queried:</p> <ol style="list-style-type: none"> 1. whether material from SAC 1, where relevant, could be incorporated into the PS; and 2. the interaction between the PS, and auditing standards and ASX listing rules, which both specify quantitative thresholds in applying materiality. |

| | |
|---|---|
| Question 3—Content of the [draft] Practice Statement | Panel member comments |
| (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? | <p>Paragraph 11 of the PS notes that the requirements in IFRS apply if the effect is material to the complete set of financial statements; otherwise, they need not be applied. A member suggested that it may be useful to include guidance to clarify the paragraph, as they were concerned that there is a risk that some entities might otherwise fail to be IFRS-compliant.</p> <p>Members have not identified other additional content for inclusion at this time.</p> |
| (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? | <p>Panel members generally agreed that the PS was understandable and helpful. Members noted the following:</p> <ol style="list-style-type: none"> 1. Generally Standards are written in a manner that is easier [for preparers] to understand now compared to the past. 2. There is better understanding of materiality when considering the primary financial statements than when considering the notes to the financial statements. The PS makes a good attempt at providing guidance on assessing materiality in note disclosures but generally has approached this with regard to the ‘easier’ note disclosures. 3. Some would question whether a note disclosure could ever be considered to be material. <p>With regards to the application of materiality to primary financial statements versus the notes, a member noted there should not be any difference as both assessments should come back to user needs. Another member considered that a distinction might be appropriate but noted a more</p> |

| Question 3—Content of the [draft] Practice Statement | Panel member comments |
|---|---|
| | challenging issue is the application of materiality to other documents such as the operating and financial review. |
| (c) Are there any paragraphs/sections with which you do not agree? If so, which paragraphs/sections are they and why? | Some members considered the PS to have a forward-looking flavour to assessing materiality, and were concerned that this could be slightly problematic in the context of financial statements that reflect historical information. These members queried whether future events should influence the assessment of the materiality or otherwise of financial statement information. |
| (d) Do you think any paragraphs/sections are unnecessary? If so, which paragraphs/sections are they and why? | A member noted that certain extracts from standards, such as those in relation to interim reporting, appear repetitive and do not provide additional information. Panel members did not identify any other paragraphs or sections as being unnecessary. |
| (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? | Members did not think there would be any conflict between the guidance and Australian regulatory requirements. A member noted there would be no conflict with <i>Corporations Act 2001</i> should the PS be finalised in its current form. Members also observed that auditors apply quantitative thresholds which are not in accounting standards, but noted there does not seem to be any conflict between assessment of materiality based on qualitative characteristics in PS and the auditors' use of quantitative thresholds. In addition, members noted potential inconsistencies between the PS and: (a) ED 260 <i>Income of Not-for-Profit Entities</i> – Paragraph 29 of the PS refers to assessing materiality on both an individual and a collective basis; however, ED 260 proposes that the assessment of whether donations are material should be made only on an individual transaction basis (without reassessment at a portfolio or other aggregate level); and (b) AASB 8 <i>Operating Segments</i> – The PS emphasises qualitative considerations in assessing materiality; AASB 8 specifies certain quantitative thresholds for identifying reportable segments. |

| Question 4—Timing | Panel member comments |
|---|--|
| <p>The IASB plans to issue the Practice Statement before the finalisation of its Principles of Disclosure project.</p> <p>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 in 2016). Nevertheless, the IASB thinks that to address the need for guidance on the application of materiality, it is useful to develop the Practice Statement now.</p> <p>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 Practice Statement. Nevertheless, the IASB will consider whether any consequential amendments to the Practice Statement are necessary following the completion of the Principles of Disclosure project. Do you agree with this approach?</p> | <p>Some panel members thought timing of issue of the PS is not critical as the principles underlying the PS are generally already being applied. In addition, some commented an earlier issuance would help encourage entities to undertake a de-cluttering exercise as the PS provides a good platform to argue for relevant concise reporting.</p> |

| Question 5—Any other comments | Panel member 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. | <p>Members commented on the structure of the document, noting that it may be more pragmatic for use if the content was restructured such that all principles were first identified, followed by examples later in the document. At present, principles, guidance and examples appear to be interwoven throughout the PS. Some members thought a section should include examples where application of materiality judgement is not easy.</p> <p>Members also noted that it may be appropriate for certain content to be incorporated into the Conceptual Framework, for example, paragraph 34 relating to immaterial obscuring material.</p> |

(b) Questions on Australian Specific Matters

| Questions on Australian Specific Matters | Panel member comments |
|--|--|
| <p>1. Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:</p> <p>(a) not-for-profit entities; and</p> <p>(b) public sector entities.</p> | Members commented they had not foreseen any regulatory issues in regard to the NFP sector, and noted that the PS is consistent with current reporting requirements. A member commented that it is in the nature of the NFP environment that jurisdictions can always require a particular disclosure, regardless of materiality. |
| <p>2. Overall, would the proposals result in financial statements that would be useful to users?</p> | Members made no further comment as to whether the proposals would result in financial statements that would be useful to users. (However, see comments to IASB Questions 2 and 3(b) above) |
| <p>3. Are the proposals in the best interests of</p> | Members made no further comment as to whether the proposals were in the best interests of |

| Questions on Australian Specific Matters | Panel member comments |
|--|--|
| the Australian economy? | the Australian economy. |
| <p>4. Unless already provided in response to specific matters for comment 1 – 3 above, any comments on the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.</p> | <p>Several members commented that the PS was unlikely to result in additional costs, nor cost savings, for certain entities. Members made the following points:</p> <ol style="list-style-type: none"> 1. Preparers that already have gone through the de-cluttering exercise are not expected to incur additional costs on application of the PS. 2. Preparers will still have to populate and collect data; accordingly, it is unclear whether there would be any significant cost savings. However, the benefit would be the streamlining of financial reports and telling the story in a more concise manner. <p>Members also noted that there has been some good take up of the de-cluttering exercise from larger entities, but the exercise has required effort. Members observed that, consequently, smaller entities were less likely to have engaged in a de-cluttering exercise, and would need encouragement to use the PS as a platform for that purpose.</p> <p>A member also noted that some politically sensitive entities may not be minded to de-clutter their financial reports to the extent it could be interpreted negatively by others.</p> |