AASB Staff Paper: To Disclose or Not to Disclose: Materiality is the Question

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Note:

The views expressed in this Paper are those of the author and not necessarily those of the AASB.

This Paper is not authoritative accounting guidance.

What is the Concern?

1 As we approach the 10-year anniversary of Australia's adoption of International Financial Reporting Standards (IFRSs), it is perhaps a good time to reflect on one of the major criticisms that has been levelled at IFRSs – disclosure overload.

2 In 2009, the Group of 100 (G100)[1] in its *Less is more* Report[2] commented that the principle-based approach used in standard setting is being contradicted by the rules-based approach to disclosure requirements. The Report was commissioned[3] because, despite the G100 regarding the existing financial reporting and regulatory framework as being of high quality, concerns had been expressed about the volume, complexity and usefulness of a number of disclosure requirements. In particular, the Report states, "… there is concern that the volume and complexity of disclosure has a potentially negative impact by distracting users from the information that is relevant to their decision making. In essence, there is a risk that quantity is outweighing quality."[4] This concern was supported by a survey conducted by the G100[5] of its members, which identified that 79% of preparers indicated that IFRSs resulted in areas of unwarranted and complex disclosures in financial statements.

3 Consistent with the G100 findings, the Australian Financial Reporting Council (Australian FRC)[6] commented in its *Managing Complexity in Financial Reporting*[7] document that "… since the introduction of IFRS, the accumulation of accounting rules and accompanying disclosures, the pace of change and the growing complexity of business, have led to calls for reductions in, and simplifications of, various

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1 G100 is the peak body for Australia's senior finance executives from the nation's major private and public business enterprises.

2 Group of 100, *Less is more*, October 2009, available at http://www.group100.com.au/publications/G100_Less-is-more_200910.pdf (accessed 21 February 2014)

3 The project was initiated in response to an invitation by Sir David Tweedie, the then IASB Chairman, to develop a set of principles for the purpose of guiding decisions when determining disclosures required by accounting standards.

4 Group of 100, *Less is more*, October 2009: page 2

5 *Ibid*

6 The Australian FRC is the government agency responsible for overseeing the effectiveness of the financial reporting framework in Australia. Its key functions include the oversight of the accounting and auditing standards setting processes.

7 Australian FRC Managing Complexity Task Force, *Managing Complexity in Financial Reporting*, May 2012, available at http://www.frc.gov.au/reports/other/managing_complexity/report/downloads/Managing_Complexity_report.pdf (accessed 21 February 2014)

requirements. The number of international reviews calling for the rationalisation of disclosures is evidence of this need being identified in relation to financial reporting."[8]

4 Concerns about the level of disclosures in financial reporting are not confined to Australia. The United Kingdom's Financial Reporting Council (UK FRC) has published two papers addressing the issue of disclosures and complexity in financial reporting – *Louder than Words*[9] in 2009 and *Cutting Clutter*[10] in 2011; both dealing with how to make corporate reports less complex and more relevant. The *Cutting Clutter* paper states "Clutter makes it more difficult for users to assess a company's progress by obscuring relevant information. Due to the time and effort involved in preparing such disclosures, clutter is also a big issue for preparers."[11]

5 The United States faces similar criticisms of US GAAP. In 2012, then Chair of the Financial Accounting Standards Board (FASB), Leslie F. Seidman, stated "Many … stakeholders tell me that financial reports are just too long – and, as a result, that they have become much less effective tools for communication with investors. Yet investors continue to say they want more information, particularly when there is a business downturn or failure. Often the information that these investors want is available in the financial statements – but it is hidden in plain sight."[12]

What gives rise to the concern?

6 So why are there these concerns? What are the possible causes of what many regard as disclosure overload?

7 The obvious scapegoat is the move to IFRSs; but is this really a fair call? Prior to the move to IFRSs in 2005, much of Australian GAAP was already converged with International Accounting Standards, so whilst IFRSs perhaps should shoulder some of the blame, they should not be held responsible for it all.

8 The Australian FRC suggests one source of financial reporting complexity (including disclosure overload) is the apparent increased aversion to risk by company directors, preparers and auditors in response to a more litigious business environment. The Australian FRC suggests this has resulted in a culture particularly among some preparers and auditors of 'when in doubt, disclose'.[13] This has the effect of increasing disclosures regardless of their materiality.

9 Respondents to the UK FRC's *Louder than Words* cite the following reasons for disclosure overload (what it refers to as the 'kitchen sink' style of reporting):

- Due to time pressures, preparers simply repeat disclosures made in prior years rather than considering whether they are still material;

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8 *Ibid*, page 2

9 UK FRC, *Louder than Words*, June 2009, available at https://frc.org.uk/getattachment/7d952925-74ea-4deb-b659-e9242b09f2fa/Louder-than-words.aspx (accessed 21 February 2014)

10 UK FRC, *Cutting Clutter*, April 2011, available at https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Cutting-Clutter-Combating-clutter-in-annual-report.pdf (accessed 21 February 2014)

11 *Ibid*, page 5

12 Remarks by Leslie F. Seidman, Chairman, FASB, Compliance Week Annual Conference, 4 June 2012, Washington DC, page 2, available at http://media.complianceweek.com/documents/36/seidman_remarks_-_compliance_w_8949.pdf (accessed 21 February 2014)

13 Australian FRC Managing Complexity Task Force, op. cit., page 6

- Just as much work is required to conclude on materiality as to prepare the disclosures;
- Desire to avoid lengthy debates with the auditors;
- Lack of confidence in making the judgement between disclosures that are material and those that are not;
- Following the leader: if another company makes a disclosure, it can influence others to follow; and
- Fear that a missing disclosure will be challenged by regulators.[14]

10 Although these might explain why we have disclosure overload, none justify it, as I argue in the following.

Time pressures

11 Time is well spent when it is used to produce succinct and useful financial statements. The objective of general purpose financial reporting (paraphrased from the AASB *Framework for the Preparation and Presentation of Financial Statements* (*Framework*)) is to provide financial information to users in making decisions about resource allocation in respect of the entity. Financial statements that are too long and complex due to excessive disclosures are not fulfilling this objective. Although the information may be there, that information must be accessible – cluttering financial statements with irrelevant information by simply repeating disclosures year after year without regard to materiality makes it more difficult for users to find what is relevant. This issue also has the potential to snowball over the years, thus exacerbating the problem.

Work required

12 Effort is well spent when it is used to produce succinct and useful financial statements. I agree it may take as much work to assess whether a disclosure is warranted or not as it does to prepare the disclosure itself. However, if after assessing that the disclosure is immaterial, then why not just leave it out? Its absence will result in less cluttered and, therefore, more useful financial statements.

Lengthy debates with auditors

13 Discussions with auditors are inevitable on a range of issues. When conducting an audit, auditors look to the requirements of the accounting standards and, if a disclosure is mentioned by a standard, their default position may be to want to understand why it is not disclosed. Therefore, if a preparer concludes that the disclosure is immaterial, they may need to have a conversation with the auditor to explain that conclusion. This should not result in a lengthy debate. If indeed the disclosure is immaterial, then concerns about audit problems are ill founded, because, as paragraph 31 of AASB 101 *Presentation of Financial Statements* states: "An entity need not provide a specific disclosure required by an Australian Accounting Standard if the information is not material." Auditors should be well aware of this paragraph.

14 UK FRC 2009, op cit., page 42

Judgement

14 Because IFRSs are intended to be principle-based, their application requires a certain element of judgement. Professional judgement is part and parcel of the accounting profession, and therefore the excuse of 'lack of confidence' in making a judgement on materiality could be perceived as merely a justification for not wanting to make a decision. The critical decision to be made regarding materiality is whether leaving out information would result in the financial statements being misleading. True, it is another decision to be made, but then so are other aspects of financial statements, including which measurement basis to use.

Following the leader

15 This excuse brings to mind 'two wrongs don't make a right'. Whilst comparability (including across entities) is one of the enhancing qualitative characteristics in the *Framework*, it does not mean that an entity should blindly make a disclosure just because another entity has done so. Financial statements are entity specific. Therefore, the fact that another entity has made a disclosure should not compel similar entities to make the same disclosure. What is relevant for one entity may not be relevant for another, and including immaterial disclosures will make it difficult for users to find the information they actually need to make decisions.

Fear of regulators

16 Although fear of regulators may be a valid concern in some jurisdictions, in Australia if an immaterial disclosure is not provided then there should be no cause to fear the regulators. In fact, in the Australian Securities and Investment Commission's (ASIC) biannual media release regarding the focus for financial reports states "ASIC's surveillance continues to focus on material disclosures of information useful to investors and other users of financial reports." The media release further states:

> ASIC does not pursue immaterial disclosure that may add unnecessary clutter to financial reports.[15]

17 It also appears there could be the start of a trend of regulators in other jurisdictions clarifying their stances. In particular, in December 2013, the Danish Business Authority (DBA),[16] which oversees non-financial entities, urged companies to look actively for any immaterial information or disclosures that could be omitted from the financial statements. IASPlus comments that this is an interesting move of the DBA because "In the past, enforcement decisions had shown that the DBA (like other regulators in Europe) focused quite extensively on every disclosure requirement in IFRSs being included; now it seems the DBA is among the first regulators to act on the main message that came out of the IASB's disclosure discussion forum in January [2013] that users, preparers, standard-setters, auditors, and regulators all

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15 This statement has been included in the past three 'Focus for Financial Reports' ASIC media releases (31 December 2012, 30 June 2013, and 31 December 2013), for example see http://www.asic.gov.au/asic/asic.nsf/byheadline/13-297MR+Focuses+for+31+December+2013+financial+reports?openDocument (accessed 28 February 2014)

16 The DBA is also known as Erhvervsstyrelsen

contribute to the perceived problems about disclosure, and that each of these parties can contribute to improvements."[17]

How can the concern be addressed?

18 The IASB has acknowledged the disclosure overload concerns and has added to its research agenda a [Disclosure Initiative] project with the aim of exploring how disclosures in IFRS financial reporting can be improved. One of the short-term steps in this project is to review how materiality is applied in practice in IFRS financial statements and consider whether there is a need for further guidance.

19 Whilst the IASB's project is a positive step, due process may take time, beginning with an Exposure Draft scheduled for release in Q1, 2014. So what can entities do now to improve the quality of the disclosures in their financial statements?

20 One significant part of the solution is for preparers to not disclose immaterial and therefore unnecessary information. The UK FRC's *Louder than Words* states:

> Part of the problem is that materiality is hard to define and seems to mean different things to different people. Materiality is based on both quantitative and qualitative factors, and the qualitative aspect is especially difficult to define. The safe option is therefore to include everything in reports so that users can make up their own minds. Unfortunately, this undermines the quality of reports as a whole.[18]

21 So how do you apply the concept of materiality? Items are considered to be material[19] if their omission or misstatement, individually or collectively, could influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, is therefore the determining factor.

22 As the UK FRC states, as noted above, materiality is based on both quantitative and qualitative factors. In addition to that, materiality is also entity specific. Until recently, AASB 1031 *Materiality* contained guidance on materiality that was additional to IFRS guidance[20] and included arbitrary levels for a quantitative threshold. Whilst this Standard was meant to assist preparers, those thresholds were not meant to be definitive, because materiality is a matter of professional judgement having regard to both the quantitative and qualitative aspects of the information. For example, some disclosures still need to be made even if they fall under the quantitative thresholds in (superseded) AASB 1031 because the information provided has qualitative characteristics that are useful to users, for example related party transactions.

23 In December 2013, the AASB withdrew much of the guidance in AASB 1031. This action was taken, consistent with the AASB's IFRS adoption policy, to bring Australian Accounting Standards in line with IFRSs by not providing further guidance that is not available in IFRSs. Some may see that withdrawing this guidance might

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17 IASPlus, News December 2013, available at http://www.iasplus.com/en/news/2013/12/danish-regulator (accessed 21 February 2014)

18 UK FRC, 2009, op cit., page 44

19 AASB 101 *Presentation of Financial Statements* paragraph 7 – definition of 'material'

20 AASB 1031 *Materiality* is an Australian-only accounting standard

make it more difficult for preparers to determine what is, and is not, material. But, in making the decision to withdraw AASB 1031, the AASB noted[21] that it would not expect the withdrawal to change practice regarding the application of materiality in financial reporting because, in particular, the withdrawal of AASB 1031 would not change the level of disclosure presently specified by the accounting standards. The AASB, in withdrawing guidance on materiality, is also 'clearing the slate' for the IASB planned revisions which may arise for its Disclosure Initiative project.

What can preparers do now to address the concern?

24 Ultimately, financial statements need to present fairly the financial position, financial performance and cash flows of an entity. To help achieve that, some use a checklist to help ensure everything is included and covered off. Without necessarily contradicting such a checklist, the following is a checklist of some of the substantive things **not** to do when making an assessment about what information should be included in the financial statements:

☑ Do **not** include every disclosure that is illustrated in a set of model accounts – model financial statements are usually a 'cater for all possible scenarios' tool and should be used critically to help ensure immaterial information is not being disclosed just because it is 'ticked off' against the model accounts.

☑ Do **not** blindly copy what other entities have disclosed. Other entities in the same industry may provide some insight to assist in your decision-making about which disclosures to include. However, disclosure materiality is specific to each entity – you need to make your own judgements about what should, and should not, be included in your financial statements.

☑ Do **not** simply repeat what was disclosed in the past year's financial statements. Circumstances change; what was relevant then may not necessarily be relevant now.

☑ Do **not** disclose your accounting policy choices if they are not relevant and necessary to understanding the information provided – AASB 101 paragraph 119 states:

> In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position. Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives allowed in Australian Accounting Standards.

Accordingly, for straightforward policies for which a standard does not provide an option, it would usually not be necessary to state the accounting policy. Generally, the less judgement needed to apply a policy the less likely it is that disclosure would be needed.

In short – if it is not relevant, do not disclose it – if you do not use hedging or have share-based payments, do not disclose a policy (do not laugh, it happens).

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21 See preface to AASB 1031 (December 2013)

- ☑ Do **not** assume your auditor will require every disclosure mentioned in accounting standards in order for your financial statements to be unqualified. It is not an auditor's role to inform the preparer which disclosures can be omitted. A preparer may need to discuss the omission of one or more disclosures (for example, particular accounting policies) with their auditor to justify why they consider disclosure immaterial. The auditor may need to obtain the reasons why a particular disclosure is considered immaterial by the preparer.

- ☑ Do **not** fear the regulators. As stated above, they are not expected to pursue immaterial disclosures. In fact, they are concerned about financial statements providing useful and meaningful information to users and not information that will add unnecessary clutter.

Closing comments

25 The 'do nots' suggested above will take some time and effort, but there should be benefits (including costs savings) for preparers as well as users. For example, entities that take the step to reduce unnecessary clutter could be seen in a positive light for being proactive in making their financial statements more user friendly. This should help mitigate some of the criticisms they may receive about the length of their financial statements. Further, over time, once an entity is in the mind-set of only providing material disclosures, financial statement preparation costs could be reduced. But of course the obvious direct benefit will be to the users of financial statements.

26 In this Paper, I have only scratched the surface of what might be done to address concerns about 'disclosure overload', focusing on what preparers could do now. Those actions, combined with future longer-term actions of standard-setters has the potential to make a marked improvement in the overall quality of financial reporting.

27 Mark Twain has been attributed (perhaps incorrectly) with apologising for writing a long letter because he didn't have time to write a short one, the same applies with preparing financial statements. Yes, it may take longer to determine which disclosures are material and which are not, than not making the distinction at all. However, taking the time and making the effort should result in reducing the clutter in financial statements, improve quality and help the financial statements meet their objective – to be useful to users.