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Mr Kevin Stevenson
Chairman
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Dear Mr ~~Stevenson~~ Kevin

ED 243 Withdrawal of AASB 1031 ***Materiality***

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to the Australian Accounting Standards Board's Exposure Draft (ED) 243 Withdrawal of AASB 1031 *Materiality*.

HoTARAC believes that the AASB should retain AASB 1031, as the removal of this significant guidance is likely to impact on the reliability of financial information reported, and heighten the risk of inconsistent materiality judgements across reporting entities.

The Attachment to this letter sets out HoTARAC's views on this Exposure Draft. Any queries regarding HoTARAC's views and recommendations should be directed to Ms Alison Cuthbert from Queensland Treasury and Trade on (07) 3035 1431 or by email to alison.cuthbert@treasury.qld.gov.au.

Yours sincerely

Grant Hehir

CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

20 August 2013

State Government Victoria

ATTACHMENT

DETAILED COMMENTS ON EXPOSURE DRAFT ED 243 Withdrawal of AASB 1031 *Materiality*

HoTARAC offers the following comments and suggestions in response to the questions in the ED and related matters.

Question 1 Support for withdrawal of AASB 1031

Whether the proposal to withdraw AASB 1031 is supported?

HoTARAC does not support the withdrawal of AASB 1031.

HoTARAC believes that the implementation of the standard has fulfilled a significant function in the practical and quantitative application of materiality since its introduction in 1986 as AAS 5 *Materiality in Financial Statements*. HoTARAC believes that AASB 1031 is effectively a low maintenance standard which provides significant widespread benefit in the consideration of materiality.

When the IFRSs were first incorporated into the Australian Accounting Standards, the Board, as explained in the ED, had decided to retain AASB 1031:

> "to ensure that the meaning of materiality remained well explained".

AASB 1031 assists in facilitating consistent quantitative assessments of materiality across Australian jurisdictions and is a major reference point for preparers and users of financial statements. It significantly supplements the qualitative assessment of materiality while still maintaining the need for professional judgement and accountability.

The importance of assessing materiality is a fundamental concept under Relevance in the *Framework for the Preparation and Presentation of Financial Statements* which states:

> "Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement."

Withdrawal of AASB 1031 would remove the indicative quantitative thresholds which clarify whether an item or aggregate of items is material (refer paragraphs 12 – 15), and guidance on the practical application of materiality.

HoTARAC does not support the AASB analysis of the removal of the above paragraphs as those:

> "... that could be omitted without a loss of meaning".

BC5 of the ED states that the withdrawal of AASB 1031 is:

> "... to achieve consistency with its policy of not providing unnecessary local guidance on matters covered by IFRSs".

HoTARAC disagrees that the quantitative content of AASB 1031 is unnecessary and is satisfactorily covered within the IFRSs e.g. the IASB *Conceptual Framework for Financial Reporting* (Conceptual Framework), IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* whereby somewhat limited quantitative guidance has been provided at a high level. AASB 1031 contains much more comprehensive guidance in paragraph 9-19, and in particular, for the Not-For-Profit sector, paragraph 17-19. In essence, this withdrawal could potentially leave a gap before the completion of the IASB's educational material on materiality is issued.

The European Securities and Markets Authority (ESMA) in its initial *Consultation Paper*[1] found:

> "... apparent differing views regarding the practical application of the concept of materiality amongst preparers, auditors, possibly users of the financial reports and, in some instances, accounting enforcers."

Furthermore, the ESMA in its *Feedback Statement*[2] considered that:

> "... a greater focus on education to improve the consistency of understanding and application of the materiality concept in financial reporting would be a useful initiative."

This is further supported by the Financial Reporting Council's (FRC)[3] *Managing Complexity Report*. The FRC noted that there has been an increase to complexity in financial reporting resulting from the accumulation of accounting rules, and accompanying disclosures, since the introduction of IFRS. This led to a call for reductions in and simplification of various requirements. A number of international reviews have called for the rationalisation of disclosures in relation to financial reporting. This report noted in particular also:

> "the challenge is to find a mechanism that encourages directors and preparers to properly consider whether or not a disclosure is material, rather than the simpler option of including all disclosures."

HoTARAC believes that given the diversity in the perspective of preparers of financial statements, and without a reasonably consistent quantitative approach to assessing materiality if AASB 1031 was withdrawn, financial statements will have greater potential to vary significantly within sectors and across entities.

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[1]European Securities and Markets Authority, 2011, *Consultation Paper*, Considerations of Materiality in Financial Reporting, p. 4.
[2]European Securities and Markets Authority, 2013, *Feedback Statement*, Considerations of Materiality in Financial Reporting, p. 7.
[3]Australian Government, Financial Reporting Council, 2012, *Managing Complexity in Financial Reporting*, Managing Complexity Task Force, p. 10.

HoTARAC recommends that at a minimum, in the interim, AASB 1031 not be withdrawn until the project to address practical difficulties in applying materiality (as noted in p5 in the ED) under IFRS is completed.

Question 2 Change from current practice

Whether the proposals in this Exposure Draft would result in a change from current practice, including whether the proposal to permit early adoption would result in the omission of disclosures that might otherwise be made, and, if so, why?

In BC 7 of the ED, the Board noted that:

> "... it would not expect the withdrawal to change practice regarding the application of materiality in financial reporting."

HoTARAC, however, believes that the basis of application of materiality will change over time, given that there would be greater flexibility in interpretation of materiality without some form of quantitative guidance being available if AASB 1031 were withdrawn, particularly with respect to different contexts.

Given the diversity in perspectives of preparers, we believe that without a reasonably consistent quantitative approach to assessing materiality, financial statements have the potential to vary significantly within sectors and across entities.

The ESMA in their *Feedback Statement*[4] stated that:

> "Diversity in application was attributed to the exercise of management judgement, the various perspectives of different stakeholder groups as well as challenges to the proper application of the concept of materiality."

The FRC[5] highlighted that where there is a mindset of preparers and auditors of "when in doubt, disclose", the consequences can be:

- "an increase in both the number and volume of additional financial and other disclosures presented;
- the inclusion of immaterial disclosures, which may detract from material disclosures, and confuse and/or deter proper review of these financial reports by targeted users and corporate stakeholders; and
- a lack of understanding by preparers and auditors as to which disclosures are material, with the result that material disclosures may be omitted from financial reports and immaterial disclosures included. ..."

[4]European Securities and Markets Authority, *Feedback Statement*, op. cit., p. 3.
[5] Financial Reporting Council, op cit., p. 6.

As staff and management change in entities, and if there is a lack of documentation of treatment of the application of materiality in that sector, reliance on the limited information available within the Conceptual Framework , IAS 1 and IAS 8 will impact on the assessment of materiality and its application in the disclosure process. As a result, there would be a significant degree of subjectivity in assessing materiality.

In the longer term, HoTARAC believes this would result in inconsistencies in practice of how materiality is understood and applied.

HoTARAC does not believe early adoption would necessarily result in the omission of disclosures that might otherwise be made.

Question 3 Regulatory issues

Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(a) not-for-profit entities; and

(b) public sector entities, including GAAP/GFS implications?

HoTARAC is not aware of any regulatory issues that may affect implementation of the proposals.

However, as highlighted in the ED's Attachment to the Basis for Conclusions table, paragraph 14 is directly relevant to not-for-profit entities given that they "are primarily concerned with achievement of objectives other than the generation of profit …". Reference is also made to guidance in paragraphs 17 – 19 as being "… more appropriate to consider". Withdrawal of the standard would therefore remove the specific guidance on materiality for not-for-profit entities.

Question 4 Usefulness to users

Whether, overall, the proposals would result in financial statements that would be useful to users?

HoTARAC believes that the withdrawal of AASB 1031 will result in a significant degree of subjectivity in assessing materiality and in the longer term, result in reduced consistency and reliability in financial reporting and hence, will reduce the usefulness of financial statements for users.

HoTARAC considers that the proposals would result in different interpretations of the inclusion of immaterial items or exclusion of material items within financial statements. Accordingly, these differences in interpretation would impact on the usefulness of financial statements to users. This may result in the manipulation of operating results which would not be in the best interests of stakeholders.

While both qualitative and quantitative aspects are required in the assessment of materiality, without appropriate quantitative guidance, there is a reasonable concern that materiality may be applied on different quantitative bases across entities and sectors.

Question 5 The Australian economy

Whether the proposals are in the best interests of the Australian economy?

HoTARAC considers that the proposals are not in the best interests of the Australian economy for all of the reasons detailed above, particularly in regard to a probable lack of consistency and reliability in financial reporting for stakeholders.

Question 6 Costs and benefits

Unless already provided in response to specific matters for comment 1 – 5 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

HoTARAC believes there may be more difficulty for preparers in assessing the consistent application of materiality in the preparation of financial statements. The time taken to determine materiality and assess consistency is also considered to contribute to outweighing the benefits of the removal of the standard.

Other comments

Recommendations if AASB 1031 was withdrawn

HoTARAC recommends that:

- since the IFRSs are principles-based, HoTARAC would support the provision of supplementary guidance of the significant components of AASB 1031, in particular paragraphs 12 to 19 within, say, the *Framework for the Preparation and Presentation of Financial Statements*; and
- a AASB review of materiality practice be undertaken after three years,

if AASB 1031 was withdrawn.

Observation

HoTARAC queries why Interpretation 21 *Levies* (AUS 14.4) has been excluded from Appendix A of the ED.

HoTARAC also encourages AASB to include into its work plan a review of similar but not standardised terminology used across various standards, involving the rationalisation of the terms "major", "significant", "key" and "main" (as alluded to in BC 9 of the ED).