

18 February 2016

The Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir

Exposure Draft 2015/8 Application of Materiality to Financial Statements

Thank you for the opportunity to comment on the Exposure Draft 2015/9 on the proposed IFRS Practice Statement "*Application of Materiality to Financial Statements*".

The IPA believes materiality is a fundamental principle in the preparation of meaningful financial statements to assess the performance, financial position, and cash flows resulting from the business activities of an entity. Currently, there is a paucity of guidance in the authoritative statements issued by the IASB regarding materiality. The IPA supports the IASB attempts to address the issue but is disappointed at the level of detail and authority proposed in the Exposure Draft.

The IPA's strong preference is for the IASB to issue an accounting standard on the application of materiality. The proposed non-mandatory nature of the proposed Practice Statement results in the guidance having little or no status in the accounting hierarchy, which the IPA believes is incongruous for such a fundamental issue.

The proposed Practice Statement contents need to be upgraded to that suitable for accounting standards including application guidance, illustrative examples and a basis for conclusion.

While the proposed Practice Statement does provide a degree of enhanced conceptual guidance on materiality, as a practical guide to the application of materiality for financial statements the absence of comprehensive illustrative examples limits its usefulness to preparers.

Our comments and responses to the questions in the Exposure Draft are set out in the Appendix to this letter.

If you would like to discuss our comments, please contact me or our technical advisers Mr Stephen La Greca (stephenlagreca@aol.com) or Mr Colin Parker (colin@gaap.com.au) (a former member of the AASB), GAAP Consulting.

Yours sincerely



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Cc Ms Kris Peach, Chairperson, Australian Accounting Standards Board

About the IPA

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members in Australia and in over 65 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures the views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) on issues affecting our members, the profession and the public interest. The IPA recently merged with the Institute of Financial Accountants of the UK, making the new IPA Group the largest accounting body in the SMP/SME sector in the world.

Appendix

Question 1 – Form of 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 is set-out in paragraphs BC10-BC15.

- (a) Do you think the guidance should be issued as non-mandatory guidance? Why or why not?*
- (b) Do you think the 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?*

IPA Response

While the IPA supports the issue of guidance on applying the concept of materiality, it is of the opinion that the guidance should be authoritative in nature, that is, an accounting standard. The concept of materiality is fundamental to the preparation of meaningful and informative financial statements.

Much of the clutter that exists in financial statements arises from a poor understanding of the concept of materiality and its application. Furthermore, the IPA believes that preparers often do not effectively consider materiality when compiling their financial reports and perceive their preparation as a compliance exercise.

The IPA also believes many preparers rely on auditors, in particular, to identify materiality on their behalf, rather than take direct responsibility for the determination of materiality in the context of the financial statements as the basis for communicating the financial performance of their business.

The IPA is of the opinion the guidance on materiality should exist within the hierarchy of accounting guidance as an accounting standard. As such, it should have structure of other standards, including application guidance and illustrative examples.

Question 2 – Illustrative examples

Do you find the examples helpful in the [draft] Practice Statement? Do you think any additional 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.

IPA Response

The IPA believes that while the examples in the proposed Practice Statement provide further exposition of the concepts set-out in the proposed Practice Statement, they fall far short as practical guidance on application of materiality. The “examples” are often no more than detailed matters to be considered in the determination or application of materiality.

The IPA believes the examples should include scenarios covering the application of materiality to recognition, measurement and disclosure in relation to:

- IFRS 7 – “Financial Instruments: Disclosure”
- IFRS 13 “Fair Value Measurement”, and

- IAS 1 “Presentation of Financial Statements” – in particular the application of materiality to the disclosure requirement relating to management judgement (IAS 1.122-124) and estimation uncertainty (IAS 1.125-133).

Any examples should not only cover the determination of materiality, but also the assessment of issues on an individual or collective basis of the facts raised in the examples.

By way of example, paragraph 28(a) notes that materiality may be more sensitive due to the application of loan triggers. While this is a relevant consideration, it does not provide any detailed guidance on the application of materiality. The IPA believes the illustrative examples should be practical in nature so in the case of paragraph 28(a), the IPA would envisage a scenario as follows:

ABC Limited was subject to loan covenants that included the company meet EBITDA targets at each reporting date of:

201x – CU22,000,000

20x2 – CU25,000,000

20x3 – CU30,000,000

In 201x the provisional EBITDA was estimated at CU22,400,000 and net profit of CU12,000,000.

In determining the provisional EBITDA and net profit amounts the company had:

- Recognised specific impairment losses in respect of receivables but has not recognised a collective provision for credit losses. Receivables in arrears but not impaired were CU1,500,000 in relation to total receivables CU20,000,000 after provisions of CU2,000,000. The recognition of a collective provision would increase the impairment provisions by CU500,000

- Investment properties had been revalued from CU200,000,000 to CU205,000,000. The fair value was determined by reference to an independent valuation in accordance with IAS 40 - depending on the capitalisation rate used and average rent per square metre the valuation provided a range of fair values of CU203,000,000 to CU206,000,000

- The company holds CU1,000,000 of unlisted debt securities classified as held to maturity. The issuer of the debt securities had recently renegotiated its banking facilities, requiring the previous covenants to be supplemented by the provision of registered first mortgages of the entities property assets. The estimate of the implicit downgrade of the credit quality of the debt securities is CU100,000.

The example should deal with the application of materiality for impact of the non-recognition of a collective impairment for receivables and potential impairment of the debt securities both in terms of net profit, EBITDA and the asset classes. In relation to the range of fair values of investment property, the example should deal with the implications for net profit, EBITDA and the asset class, but also in relation to the IFRS 13. The implications for the disclosures of management judgement and estimation uncertainty should also be addressed in the example.

Question 3 – Content of the [draft] Practice Statement

The [draft] Practice Statement proposes guidance in three main areas:

- (a) Characteristics of materiality;*
- (b) How to apply the concepts 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 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 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 aspect of the guidance will conflict with any legal requirements related to materiality within your jurisdiction or a jurisdiction in which you file financial statements?*

IPA Response

As set out in the response to Question 1, the IPA would prefer the Practice Statement to be replaced with an accounting standard addressing the application of materiality, including application guidance and illustrative examples sections.

The IPA is also of the view the proposed Practice Statement as drafted is more of a conceptual document and, therefore, provides little in the way of practical guidance on the application of materiality. In particular, and as stated in the response to Question 2, the existing examples are not sufficiently detailed nor comprehensive to provide practical guidance. They are often just specific considerations in the application of materiality.

Structurally the guidance also needs to follow a procedurally-based approach to the determination of materiality starting with an assessment of the importance to users in assessing the drivers of financial performance of the entity's business. This understanding should be applied to the requirements of the standard and assessing the circumstances surrounding the results of business for the period.

While the proposed Practice Statement does provide a stronger conceptual understanding of the application of materiality, as a document to assist preparers in the application of materiality on a practical basis the proposed Practice Statement is of limited use.

As a conceptual document, the IPA does not disagree with any paragraphs/sections. The IPA does not believe there are any unnecessary paragraphs/sections, but would note that the structure of the Practice Statement would be enhanced by a more procedural format.

The IPA does not envisage any significant conflicts with legislation within the Australian jurisdiction.

Question 4 – Timing

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

The IASB tentatively decided to include a discussion of materiality, and whether there is a need to change or clarify the definition of materiality in the Discussion Paper for its Principles of Disclosure project (expected to be issued early 2016). Nevertheless, the IASB thinks that to address the need for guidance on the early application of materiality, it is useful to develop the Practice Statement now.

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?

IPA Response

As previously stated, the IPA is of the view the application of materiality is fundamental to the preparation of meaningful financial statements. The IPA agrees with the need to develop guidance on the practical application of materiality without waiting for the issue of the discussion paper on the Principles of Disclosure project.

Question 5 – Any other comments

Do you have any other comments on the [draft] Practice Statement? As mentioned in Question 4, a discussion about 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.

IPA Response

The IPA has a strong preference for an accounting standard on the application of materiality rather than a non-authoritative Practice Statement.

However, if the IASB persists with a Practice Statement, the contents should be an appendix to the Conceptual Framework. As such the IPA reiterates the view that the Conceptual Framework should be considered as part of the accounting hierarchy and IAS 1 should explicitly acknowledge the status of the Conceptual Framework. A formal status in the hierarchy would allow preparers to consider the Conceptual Framework when selecting accounting policies where there was no existing standards covering the circumstances being deliberated upon.

The IPA believes the IASB needs to address the application guidance on materiality incorporated in ISA 320 “Materiality in Planning and Performing an Audit”. The application guidance at ISA 320.A3-A11 is more specific when compared with the proposed Practice Statement. As the IPA has noted, many preparers default to their auditors when assessing materiality, as such, at a minimum there should be a level of consistency in guidance between ISA 320 and any guidance issued by the IASB.