Federation of European Accountants

Mr Hans Hoogervorst
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Sent by email:
Commentletters@ifrs.org

Brussels, 19 February 2016

Subject: The Federation of European Accountants comments on IASB Exposure Draft: *IFRS Practice Statement Application of Materiality to Financial statements* (ED/2015/8)

Dear Mr Hoogervorst,

The Federation of European Accountants (www.fee.be) is pleased to provide you below with its comments on the IASB's Exposure Draft (ED) *IFRS Practice Statement Application for Materiality to Financial statements*.

(1) The Federation supports this initiative as the next step of the IASB's Disclosure Initiative project. We believe that this project will continue to enhance the relevance of financial reporting. We support the IASB's step-by-step approach for the Disclosure Initiative and its current project to provide guidance to help management apply the concept of materiality when preparing general purpose financial statements in accordance with International Financial Reporting Standards (IFRS). We note, though, the importance of explicitly mentioning in the Practice Statement that materiality should be looked at in the context of the financial statements as a whole, and not only when disclosing information in the notes.

(2) We believe that the Practice Statement can be used as the basis to assist preparers on applying the concept of materiality but it needs some improvements to be a practical tool. Additionally, it can facilitate other stakeholders to understand the approach that management develops when making judgments about materiality in the preparation of the financial statements.

(3) We also support the IASB's decision to issue the document as a Practice Statement in a non-mandatory form as we believe it will avoid the potential risks of conflicting with national laws and/or legal requirements.

(4) In our view, despite the fact that the Practice Statement can assist management in assessing materiality, we observe that in practice it is likely, in terms of making a change in the behaviour of preparers, to be insufficient. For example, a decision to disclose or not certain information might expose management and auditors to the risk of being criticised by another

stakeholder (e.g. regulators, court, shareholders) which might take a different view on the materiality assessment. Although materiality should be perceived through the eyes of users, preparers might not perceive the value added to users when being more selective on information provided, noting that the related process to achieve this outcome might be perceived as burdensome, time consuming and potentially giving rise to delays in the issuance of financial statements.

(5) In this regard, we believe that only a collaborative change in the relationship between regulators, auditors and preparers could ultimately contribute to a change in behaviour. In our recent publication: the *Future of Corporate Reporting*[1], we include a discussion regarding the efforts that are needed from the policy makers and regulators to achieve a change in behaviour that enables the change and innovation in the future.

(6) To this end, we also believe that it is important that the IASB considers how the nature and content of this document could potentially affect other constituents and in particular auditors. While the International Standard on Auditing (ISA) 320 clarifies that the concept of materiality is an accounting concept which is defined by the applicable financial reporting framework, we are aware that the International Auditing and Assurance Standards (IAASB) has been asked by some of its stakeholders, in particular by regulators, to provide more guidance for auditors on the application of materiality. Therefore, we suggest that the interrelationship of how the concept of materiality is applied in different contexts is further explored and better articulated in cooperation with the IAASB.

(7) The Practice Statement provides some guidance regarding the concept of materiality in the context of fraud. However, the Federation recommends that the Practice Statement clarifies the difference (if any) between a misstatement as a result of an error and as an outcome of an intentional act (or fraud) and whether the latter would be considered material irrespective of its quantitative impact on the financial statements.

(8) Finally, we also agree with the IASB's approach to develop a draft of the Practice Statement before the publication of the Discussion Paper on the *Principles of Disclosures*; however, this Practice Statement might need to be updated as part of the completion of this wider project, especially to take into account a potential redrafting of the definition of materiality as well as after the completion of the revised *Conceptual Framework for Financial Reporting*.

Our responses to the specific questions can be found in the attached appendix to this letter.

For further information on this letter, please contact Pantelis Pavlou on +32 (0)2 893 33 74 or via e-mail at pantelis.pavlou@fee.be.

Kind Regards,
On behalf of the Federation of European Accountants

Petr Kriz
President

Olivier Boutellis-Taft
Chief Executive

Encl. Appendix – The Federation comments on ED Questions

[1] http://bit.ly/15futurecorprep

Appendix - Detailed comments to the IASB's questions

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

b) (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?

(1) We welcome the efforts of the IASB to issue a document that brings the guidance on materiality together in an effort to assist, primarily, preparers to apply the concept of materiality when preparing financial statements.

(2) We agree with the analysis that the concept of materiality is mandatory, as it is defined in the IFRS literature, irrespective of the form of the guidance on its implementation. The fact that a Practice Statement is subject to a full due process, will enhance the quality of the guidance, which is introduced.

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.

(3) We appreciate the efforts made by the IASB to provide some examples and also the difficulty to produce them in such a highly judgemental area. We note that some of the examples in the Practice Statement might be helpful; however there are cases where clearer and more specific examples could be included to further assist in clarifying the main principles. Additional examples could be included on those areas where judgment is difficult to exercise (e.g. estimates and uncertainties).

(4) For instance, we consider that a more useful example should be provided on IAS 19 *Employee Benefits* than the one described in paragraph 53 (b) which would not only reflect on the quantitative but also on the qualitative aspects of the financial statements. For instance, large companies which may have various quantitatively material plans are obliged to disclose these based on the requirements of IAS 19, however in respect to relevance, we wonder the extent to which full disclosure maybe useful to understand the business of the entity and to influence the primary users'-when making decisions.

(5) Another area which could be developed further is the preparation of the interim financial statements. The discussion around interim reporting in the ED repeats the guidance of IAS 34 Interim financial reporting, without providing any practical examples to assist preparers in the application of materiality. We, therefore, suggest incorporating an example on how to apply materiality to interim financial reporting.

(6) We also believe that illustrative examples should demonstrate both decisions to include or to omit information from the financial statements and not over-emphasise the first aspect. We are convinced that including unnecessary/immaterial information could equally adversely affect decision-making by hiding or obscuring more important information.

(7) Furthermore, we note that it is not well-defined in the second sentence of paragraph 28 (c), "…For example, a transaction may be unusual because it was on special terms with a related party of the entity …", whether the transaction is material because it is based on special terms (qualitative factors), because of the amount itself (quantitative factors), or because it is a contract with a related party. We therefore suggest that the Board better clarifies this example.

(8) Finally, we believe that the ED could provide a useful example on how materiality is applied when it comes to the disclosures of related party transactions.

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 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:

c) (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?

d) (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?

e) (c) Are there any paragraphs/sections with which you do not agree? If so, which paragraphs/sections are they and why?

f) (d) Do you think any paragraphs/sections are unnecessary? If so, which paragraphs/sections are they and why?

g) (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?

Question 3(a)

Qualitative and quantitative assessment

(9) We believe that it is worth elaborating in the Practice Statement more about the qualitative aspects that would shape management's decisions. In particular, there should be more guidance on how management determines that a transaction or an event is material in the light of qualitative factors, especially when that particular transaction is deemed not material in terms of quantitative factors.

(10) We suggest that the section 'qualitative and quantitative assessment' clearly distinguishes the factors pertaining to qualitative and quantitative assessment.

Stewardship

(11) In line with our comments to the IASB's ED on the *Conceptual Framework for Financial Reporting*[2] we support the IASB's efforts to reintroduce the concept of 'stewardship' in its framework. Therefore we also support the references made in the Practice Statement to stewardship. However, we suggest to

[2] http://www.fee.be/index.php?option=com_content&view=article&id=1540&Itemid=106&lang=en

clarify or revise paragraph 22(a), as we do not believe that management should consider how users "think the entity should be managed (i.e. stewardship)" when assessing materiality.

Scope

(12) We support the fact that the Practice Statement covers materiality in the application of IFRS as a whole, not only for presentation and disclosures aspects, but also in respect to recognition and measurement aspects. However, the section on recognition and measurement is limited to practical expedients and misstatements.

(13) Regarding practical expedients, even though we do not disagree with paragraphs 63-66, we do not believe that their inclusion in this Practice Statement is either necessary or relevant to the assessment of materiality. In our view, the discussion on practical expedients is included in the individual standards and we suggest that the Practice Statement excludes them from its scope.

(14) We also observe that the Practice Statement dedicates an unbalanced portion of its guidance to disclosures when compared to recognition and measurement. If the IASB is expecting to include in the scope of the Practice Statement guidance on recognition and measurement, we believe that the proposed guidance might not be sufficient to help preparers assess materiality in this respect.

Question 3(b)

(15) We think that the guidance will be understandable by preparers of financial statements since it is anticipated that such persons have the necessary knowledge and skills to be able to understand and apply the guidance. We include below some comments that, in our view, could enhance the guidance in the ED.

(16) In addition to the comments made above regarding question 3(a), we believe that the discussion around prior period errors in paragraphs 75-76 recycles the guidance included in IAS 8 *Accounting Policies, and Changes in Accounting Estimates and Errors* without providing additional guidance on how to apply the main principles. We would suggest that the IASB better articulates this section in order to assist preparers in applying the guidance of the standard. For example, the Practice Statement could clarify whether a misstatement should be assessed with respect to the current period, prior periods or both. We also suggest that the IASB revisits paragraphs 68 and 79 of the ED. From a user's point of view, there is an important difference between the two types of misstatements and therefore, to avoid any unintended consequences, we strongly suggest that the IASB better articulates those paragraphs and explains the differences between error and fraud with respect to materiality.

(17) We also suggest that the IASB reconciles the last sentence of paragraph 78 of the ED with the wording of paragraph 41 of IAS 8 to address the inconsistency between two diverging statements, one considering it is material (paragraph 78 of the ED) and the other one considering it is not material (IAS 8.41).

(18) Lastly, while we agree with paragraphs 34-36, which discuss the notion of immaterial information, still the IASB should consider that the judgements on materiality do not have to do merely with disclosing or not disclosing information but also about its prominence. When there is reference to obscuring information, we believe that the word 'obscuring' is both an aspect of materiality but also an aspect of giving undue prominence to information. Therefore, our expectation is that the IASB further discusses the 'prominence' of information and the 'obscuring' of information in the context of the Discussion paper on the *Principles of Disclosures.*

Question 3(c)

(19) We agree with the main principle in paragraph 58, stating that the financial statements should be a comprehensive document. However, we note that the current IFRS literature, allows, at times, incorporating information by reference (for example certain information required by IFRS 7). Paragraph 58 might need to take exception to such IFRS allowed practices, for the avoidance of doubt.

(20) Whilst we agree with most of the comments raised in the Basis for Conclusions (BC18-BC20) we believe that the last sentence of paragraph BC20 is misleading. We agree that management should not just automatically use the materiality thresholds set by the auditor but this sentence could be interpreted that management cannot use the same materiality thresholds as the auditor. The International Standard on Auditing (ISA) 320 clarifies that materiality is an accounting concept, and thus similar principles may be applied by management and auditors when making judgments about the concept of materiality. Therefore, we suggest that the interrelationship of how the concept of materiality is applied in different contexts is further explored and better articulated in cooperation with the International Auditing and Assurance Standards Board (IAASB). This is especially important as we are aware that the IAASB has been asked by some of its stakeholders, in particular by regulators, to provide more guidance for auditors on the application of materiality.

Question 3(d)

(21) There are numerous cases whereby information is repeated or similar meaning is reproduced, without any added value in the guidance. We believe deleting duplication would enhance readability and usefulness of the Practice Statement.

(22) The duplication has been identified particularly in the references to IAS 1 *Presentation of Financial Statements*, IAS 8 *Accounting Policies, and Changes in Accounting Estimates and Errors* and the *Conceptual Framework*. Therefore we suggest to include the various references in the section of 'General Characteristics' and refer to those by cross-reference only in the Practice Statement.

Question 4 – Timing

The IASB plans to issue the 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 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.

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?

(23) We agree with the IASB's approach to develop a draft of the Practice Statement before the publication of the Discussion Paper on the Principles of Disclosures.

(24) We do believe though that the IASB should clarify the paragraphs in the Practice Statement which include definitions from the draft discussion paper on the Principles on Disclosures. We also understand that there may be further guidance on materiality developed as this project concludes; therefore this guidance needs to be a 'living document'. Moreover, we believe it is important to

update as needed the Practice Statement upon completion of the revised Conceptual Framework project.

(25) We cannot express any views on the guidance and paragraphs which refer to the primary financial statements versus notes (paragraphs 40-48). We will provide our comments on those definitions and objectives once we comment on the DP on the Principles on Disclosures.

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.

Objective and purpose of the Practice Statement

(26) We agree with paragraph BC17 where the Board explains that an objective of this statement is to help stakeholders to understand the approach that management follows when making judgments about materiality when preparing financial statements. Consequently, we would suggest adding this reference in paragraph 1 of the ED as part of the objectives of this IFRS Practice Statement.

Barriers in assessing materiality

(27) We believe that the Practice Statement is likely to be useful overall and it is contributing to further enhance the relevance and quality of the financial statements. However, we have identified some barriers from a preparer's perspective, with respect to the application of the materiality concept with regard to disclosure.

(28) Deciding to disclose or not to disclose certain information might expose management and auditors to the risk of being criticised by another stakeholder (regulators, court, shareholders…) which might take a different view on the materiality assessment.

(29) Preparers also might not perceive the value added to users when being more selective on the information provided, noting that the related process to achieve this outcome might be perceived as burdensome, time consuming and potentially giving rise to delays in the issuance of financial statements.

(30) To overcome those barriers, we believe that fostering a cooperative relationship between users, regulators, auditors and preparers could eventually contribute to a change in behaviour.