Comments on the IFRS Practice Statement: Application of Materiality to Financial Statements

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) Do you think that the guidance should be issued as non-mandatory guidance?

Our experts are divided over this matter. Many believe that the guidance should be mandatory, like, for example, IFRS 13 *Fair Value Measurement*, which also sets out guidance to assist an entity in forming judgment when preparing financial statements. It is hard to understand why the guidance on fair value measurement should be mandatory, while the guidance on assessing materiality is non-mandatory.

Mandatory guidance on materiality can be formalized as a separate standard or amendment to the existing standards, first of all, to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and IAS 1 *Presentation of Financial Statements*.

The reasons for issuing non-mandatory guidance, as stated in paragraphs BC10-BC15, come down to the following two aspects: conflicts with the requirements of a particular jurisdiction and the risk of undermining management judgment. Both of these reasons seem to be quite weak.

In the process of developing IFRS a potential conflict with national legal frameworks has hardly ever been taken as a reason for making an IFRS requirement non-mandatory. At the same time, such a conflict may well occur in regard to standard accounting matters, e.g. recognition, measurement or classification, as national legal frameworks can be substantially different from IFRS requirements. An entity may violate some requirements by fulfilling others. However, this is not the case for the application of materiality. The requirements are unlikely to differ in substance, because the difference, if any, is in the degree of stringency: some are stricter than others. Meeting stricter requirements does not mean that less strict requirements are violated. Therefore, an entity can always meet both IFRS and national legal requirements, as confirmed in paragraphs BC11 and BC12 of the [draft] Practice Statement.

The risk of undermining management judgment is addressed through the content of the document rather than its form. If IASB believes that, when applying the concept of materiality, an entity should rely on management judgment rather

than on overall guidance, this should be stated in the document. IFRS 8 *Operating Segments* and IFRS 9 *Financial Instruments* provide guidance on the selection of reporting segments and a model for classifying debt financial instruments, respectively. This is a good example of how an approach based on management judgment can be presented in a standard.

First, a basis for applying the concept of materiality must be developed, and only after that does an entity consider how this concept should be applied. This basis should be specified in standards rather than in other documents. Currently, there is no such basis. The concept of materiality is the *tabula rasa* of IFRS. IAS 1 and IAS 8 just briefly state that it is not necessary to apply certain IFRS requirements if the consequences of not applying them are immaterial, and also that financial statements should not contain material omissions or misstatements.

The standards do not even define the concept of materiality. IAS 1 and IAS 8 define material omissions or misstatements rather than materiality. The application of materiality is considered only in the context of omissions or misstatements. The standards do not indicate that financial statements, their content and format depend on the concept of materiality.

The matters described in BC2 and BC3 that prompted the Practice Statement cannot be addressed by issuing a non-mandatory document. Checklists are very convenient for entities preparing financial statements and for auditors. Nothing in IFRS states that such a practice is inappropriate. Paragraph 30A, added to IAS 1 in December 2014, is not enough to address these matters. Until the relevant provisions are included in the standards, entities preparing financial statement and auditors will use checklists, and the length of financial statements will increase.

While agreeing with these arguments, some of our experts supported non-mandatory guidance. The fact is that the concept of materiality is applied not only in preparing financial statements, but also in a number of related areas, including the relevant legislation. At the same time, legislation does not provide clear guidance on applying the concept of materiality.

Since IFRSs are mandatory in Russia, guidance on the application of materiality issued in the form of a standard will be adopted in the national legal framework. In the absence of other guidance, this standard will be applied not only in preparing financial statements, but also for purposes outside the scope of financial reporting, and our experts are concerned that this may have undesirable consequences for Russian entities.

(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?

As for the form of non-mandatory documents, the form of the Practice Statement seems to be the most appropriate, because it emphasizes the pervasive nature of the documents, as stated in paragraph B14.

At the same time, the way the text is presented in the document leaves much to be desired. Provisions covering fundamental approaches to the assessment of materiality, various comments, particular provisions, illustrative examples, are mixed together. Moreover the document is full of quotas from other IFRSs and references to them (see the answers to questions 2 and 3). As a result, it is difficult to grasp the content.

We believe that the structure of the document should separate provisions that are different in nature.

Also, as we have already stated (see response to (a)), we wonder why it is inappropriate to include guidance on materiality in standards in the form of a mandatory document. If this guidance is adopted as a standard, only some of its paragraphs, which represent requirements, should be included in the standard rather than the whole text. These might be approximately the paragraphs 1–3, 11, 12, 14, 16, 24–26, 29–35, 38, 41–46, 50–52, 57–59, 62, 65, 70–73, 76 and 78. Other descriptive paragraphs can be presented as Application Guidance and Illustrative Examples to the standard. We thus believe the most appropriate way to implement this guidance in the IFRS system is to issue it as a standard together with Application Guidance and Illustrative Examples. Such a structure should be used even if this guidance is issued in the form of a non-mandatory document, such as a Practice Statement.

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.

Examples are given in the main text of the document, which is inconvenient. This format is not typical for IFRS. We suggest presenting illustrative examples in a separate section or at least using a different font or highlighting them (see response to answer 1b).

We believe that the content of the majority of examples is helpful, but we have critical comments on some of them.

The examples in paragraph 22 describe the content of information to be presented in financial statements rather than its materiality and this goes beyond the scope of the document. All IFRSs describe what information should be presented in financial statements, and this does not relate to the concept of materiality.

The examples in paragraph 27 illustrate paragraphs 25 and 26 and should have dealt with cases in which quantitative aspects may be misleading in making assessments about materiality. The example in paragraph 27(a) has no relation at all to quantitative aspects and is thus inappropriate, as it is not illustrative for these purposes. The example in paragraph 27(b) says (along with other relevant aspects) that the potential financial effect and timing of cash outflows should be considered. But these two aspects are quantitative and the example thus has no sense.

We also doubt the correctness of the example in paragraph 39(b). The logic of the example is based on the difference between speculative transactions and recurring transactions. This difference is probably evident for banks and other financial institutions, but a non-financial entity will be unable to differentiate between speculative and recurring transactions.

The [draft] Practice Statement gives many examples relating to the application of materiality in disclosures. However, there is a lack of examples of the application of materiality in recognizing, measuring and classifying components of financial statements, i.e. in applying IFRS requirements. The [draft] Practice Statement gives only one example (see paragraph 64) in which smaller amounts regarded as immaterial can be recognized as expenses instead of being capitalized as required by IFRS.

This example is very relevant, because the matter is of high importance for entities applying Russian accounting principles. But the example does not address the key issue: what accounting unit should a value threshold be applied to? An entity may purchase low-value assets while the total effect of a large number of such assets will be material for the financial statements. Similarly, the cost of renovation or overhaul in each individual case may be insignificant, but the total effect of a large number of renovations and overhauls may be material. The example should show how to determine correctly the unit to which a value threshold should be applied in order to avoid significant deviations from IFRS; otherwise, the example is unhelpful.

The Practice Statement should give many more examples of the application of materiality in recognizing, measuring and classifying components of financial statements. The need for such examples is also indicated in the response to answer 3(a).

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:

(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?

We believe that the following matters should to be covered by the [draft] Practical Statement:

1. Scope.

Paragraphs 2 and 3 deal only with financial statements to which the concept of materiality is applied. It is necessary to identify aspects of preparing financial statements to which materiality is applied and how it is applied. IFRSs often contain such word as *large*, *significant*, *high*, *strong*, etc., as well as *small*, *insignificant*, *low*, *weak* and other terms, but they are rarely explained. Entities preparing financial statements are expected to use their professional judgment in interpreting these terms. Generally, it can be assumed from the context that such terms as *big*, *significant*, and *high* are synonymous with *material*, and that *small*, *insignificant*, *low*, *weak*, etc., are synonymous with *immaterial*.

This is not always the case, however, as can be demonstrated in the recently issued IFRS 16 *Leases*. Paragraph 5 of the standard states that a lessee may not apply some provisions regarding short-term leases or leases of low-value assets. Everything is clear with a short-term lease. This term is included in the definitions and linked to a 12-month period, so the concept of materiality cannot be applied. This is not the case for low-value assets. Paragraph B4 states that "leases of low-value assets qualify for the accounting treatment in paragraph 6 regardless of whether those leases are material to the lessee." Therefore, the concept of materiality is not applicable here either. The question is what can be applied? The same paragraph states that "the assessment of whether an underlying asset is of low value is performed on an absolute basis." As far as we know, there is only one

value that can be called "absolutely low", and that is absolute zero -273.15° C or -459.67° F ☺. Based on the further explanations in paragraphs B6 – B8, it can be only concluded that vehicles have high value and that "tablet and personal computers, ***small*** items of office furniture and telephones" are low-valued. The question as to which items of office furniture and telephones are small and which are large remains open, regardless of the special clarifications in the standard.

And what do we do when there are no such clarifications? The example in IFRS 16 is an exception rather than a typical case. In most cases, standards provide no clarifications on such matters at all. The Practice Statement should thus clearly identify the cases in which the approaches to materiality described in this document should be applied, and the extent to which they should be applied, in forming a judgment concerning such terms as *big/small* and their synonyms used in IFRSs. These terms could not be avoided even in the draft document. For example, paragraph 19 of the Practice Statement says that "information would usually be expected to be material if it is relevant to … a ***significant*** class of primary user (for example a class with a ***large*** number of users)." The question is how an entity can decide whether a class of primary user is significant or not and particularly whether the number of users is large or small.

2. Unconventional items

Financial statements prepared by entities often use such words as *other* or *miscellaneous* in the name of line items that are unconventional and not clearly identified in IFRS. This practice is widespread, partially due to IFRSs, and the best example of this is the term "***other*** comprehensive income."

However, based on the ideas contained in the concept of materiality, these terms can be used only for line items that aggregate immaterial information rather than for unconventional items. If a line item is material, an entity should give it a name that reflects its content, and the line item should be presented in the financial statements under this name. We believe that presenting material line items in primary financial statements with the words *other* or *miscellaneous* is inconsistent with the concept of materiality, even if these line items are disclosed in notes. We suggest to clarify this matter in the Practice Statement.

3. Numerical reconciliation

The statement of financial position has traditionally been called the balance sheet. The left and right sides of a balance sheet (resources and claims) are always balanced, but there is no IFRS requirement that both sides be equal. In theory, entities can present only material items in the statement of financial position, and the balance sheet thus will not balance.

The same applies to the statement of profit or loss and the statement of comprehensive income. Traditionally, this statement is prepared by adding up income and deducting expenses with the result being mathematically derived. This is only a tradition, however, not a requirement. An entity may include only material items in the statement, which may result in an arithmetic discrepancy. IAS 1 makes the situation even more uncertain. It states that expenses analyzed by nature or function may be presented either in the statement or in notes at the entity's discretion.

However, regular user, for whom the concept of materiality has been developed, is accustomed to a statement of financial position where the left side and the right side are in balance and to a statement of profit or loss where the amount in the last line item is the sum of all preceding line items. The user will be confused by anything else.

Does this make the presentation of immaterial items in primary financial statements mandatory from the point of view of the concept of materiality? We believe this matter should be addressed in the document.

4. Practical expedients

The draft focuses on the application of materiality when disclosing information in the financial statements. As indicated in the question, it also contains a short section on applying materiality when applying recognition and measurement requirements. This section is really too short. Our experience shows that there are more practical problems involved in the application of materiality to recognition and measurement requirements than to the disclosure of information in the financial statements. This question should thus be given special consideration in the Practice Statement.

In practice, entities often justify a liberal application of IFRS by reference to practical expediency, based on the cost-benefit principle. When it is difficult to comply with a standard, an entity claims that the effects will be immaterial.

Specifically, the application of materiality to consolidation raises serious concerns. It has become common to prepare consolidated financial statements by summing the accounts of separate financial statements instead of using consolidated accounting data. Such summing requires an entity to make multiple adjustments, which adversely affects the accuracy of the result. For example, the amount of goodwill is rarely determined in accordance with IFSR 3 *Business Combinations,* since such information cannot be obtained from separate financial statements. In this case, a retrospective assessment of a non-controlling interest should be performed. Instead, entities make adjustments that rely on rough

estimates and judgments based on current data in separate financial statements. Such a practice is commonly justified by reference to expediency.

The Practice Statement should provide detailed comments on this matter.

(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?

We think that the proposed guidance will be fairly understandable and helpful to its potential users.

However, there are certain deficiencies.

The objectives of financial statements and their components have been worded very carelessly. Under paragraph 30, the primary objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity. At the same time, under paragraph 41, the role of the primary financial statements in meeting the objective of financial statements is to provide information that gives an overview of the financial position and performance of an entity. Here cash flows are not mentioned. The provision of information on cash flows is thus the objective of the notes, but not of the primary financial statements. This is nonsense, of course, but it follows from the text.

Furthermore, paragraph 41 explains how to attain the objective of financial statements. Clause (a) finds it useful to obtain essential information on an entity's assets, liabilities, equity, income, expenses, cash flows and contributions and distributions from/to holders of equity claims. Here we see cash flows again. Maybe they are merely an indicator of financial performance along with income and expenses? But why are they indicated separately and not included in the definition of financial performance in paragraph 30? In addition, contributions and distributions from/to holders of equity claims are mentioned. What do they have to do with financial position and performance?

Paragraph 41 (a) repeats paragraph 40 almost word for word. Why mention the same thing twice? The only difference is the word "recognized," which is used in paragraph 40 but not in paragraph 41 (a). Does this have any hidden meaning? Why does it refer only to assets, liabilities, equity, income and expenses, but not to cash flows and contributions from, or distributions to, holders of equity claims? Maybe this word means that the primary financial statements should present only recognized assets, liabilities, equity, income and expenses, whereas unrecognized items, contingencies for example, should be presented in the notes? But paragraph 41 refers to the primary financial statements, not the notes. Moreover, the statement of cash flows and statement of changes in equity, which present

cash flows and contributions from, or distributions to, holders of equity claims, are part of the primary financial statements, not the notes.

Wording relating to components of the financial statements should be formulated with greater care. This wording needs to be revised throughout the document.

The following phrase in paragraph 30 is poorly worded: "Judgments on whether information is material should be made within the context of this *[financial statements]* objective and by considering the complete set of financial statements (i.e. the primary financial statements together with the notes)." It can be concluded that materiality should be assessed for all primary financial statements and notes based on common criteria. This phrase seems to contradict the following paragraphs starting with paragraph 38, which indicate that materiality for primary financial statements and materiality for notes are assessed differently. Only paragraph 46 says that different contexts are the reason for different materiality assessments. Paragraph 30 should thus be revised, and information on context in paragraph 46 should be given earlier – in paragraph 30, for example – so that the meaning of paragraphs 38-45 is clear.

Paragraph 57 seems self-contradictory. In particular, it can be concluded from the first three sentences that the assessment of materiality depends on additional information from public sources. This means that the same information can be regarded as material or immaterial for financial statements, depending on its public availability in additional sources. But the last sentence seems to deny this conclusion. And the following paragraph 58 only adds to the confusion. These paragraphs should be rewritten so that it is clear how to take additional information into account when assessing materiality for the financial statements themselves.

Two sentences in paragraph 62 are poorly worded.

It could be concluded from the first sentence that recognition and measurement requirements should not be applied if their effect is immaterial. But this is incorrect. If we were talking about disclosures, the disclosure of immaterial information could have the undesirable effect of obscuring material information, but this does not apply to recognition and measurement. Recognition and measurement requirements may be applied by entities regardless of whether the effects are material. An entity may depart from these requirements when the effect is immaterial only from a perspective of practical expediency. The wording "***are applied*** if their effect is material" is not the same as "do not have to be applied if their effect is immaterial."

In the second sentence of this paragraph, the phrase "***immaterial*** errors made intentionally to achieve a particular presentation" is used. Under paragraph 78, however, such errors (misstatements) are material by definition. And that is

reasonable, since such errors can predetermine the result and thus influence the decisions of users, which is the main aspect of materiality.

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

We do not agree with paragraph 3. In substance, this paragraph repeats paragraph 21B of IFRS 7 *Financial Instruments: Disclosure,* which we do not agree with either. We think that its content contradicts paragraphs 10-14 and 49-52 of IAS 1. Paragraph 3 of the Practice Statement also directly contradicts paragraph 58 of the same document, but this is not relevant to the concept of materiality that is under discussion.

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

Obviously, the paragraphs that simply repeat IFRS and other related documents are unnecessary. These include paragraphs 7, 8, 13, 15, 20, 37, 49, 60, 68, 74, 75 and 77 and form a significant part of the draft. Why not provide references instead? There are many such references in the draft too. So it is unclear why in some cases there are references to the sources, while in others there are direct quotes from the documents. In addition, how will the Practice Statement be updated if the standards are amended? Will the quotes be revised every time the standards change?

(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?

In Russia, quantitative criteria of materiality are established for exceptional cases.

For example, entities do not have to recognize low-value assets as property, plant and equipment, even though they meet the criteria of property, plant and equipment. The value threshold, although set by the entity itself, must not exceed the one prescribed by regulation. In various periods, this threshold has been RUB 10,000, RUB 20,000, RUB 40,000 and RUB 100,000.

An entity's income exceeding 5% of total income for the reporting period should be presented separately in the income statement. The same requirement applies to expenses.

We don't think that these facts can be called a *conflict*. As we said in our answer to Question 1 (a), an entity may adhere to the threshold that is stricter in the given circumstances. The presentation of property, plant and equipment will not violate either national requirements or the Practice Statement. The

presentation of income and expenses could theoretically cause the problem described in paragraph 35, but this is unlikely in practice.

Moreover, these criteria are expected to be eliminated from regulatory documents in the near future, making this question irrelevant.

We see no other potential conflicts with Russian law.

However, as described in question 1 (a), some of our experts are concerned that the document may be used for purposes other than financial reporting, and this could have unintended consequences.

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?

We agree with the IASB's approach to issuing the documents.

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.

Throughout the draft, the wording “management should consider” or “management should exercise judgment,” etc., is used. It is never specified, however, that what is meant is the management of a reporting entity. This is unusual for IFRS, which normally refer to entities. And so they should. IFRS requirements are always applied by a specific legal entity. Even for consolidated financial statements, IFRS requirements are applied by a specific legal entity – the parent company. Who is responsible for preparing the financial statements is a matter of how functions are allocated within the entity. It is not recommended

that financial statements be prepared by management (in the traditional sense of the word) rather than by an accountant. This violates the principle of neutrality and results in a conflict of interest, as management's bonuses are calculated based on the financial statements. In such cases, the application of materiality has a high risk exposure. But materiality for external users is not the same thing as materiality for management bonuses. This is exactly what is described in paragraphs 77-79 of the draft. We recommend adhering to IFRS wording and using the term *entity* throughout the Practice Statement.

<u>We noted two misprints in the document:</u>

In the first sentence of paragraph BC7, the word *that* is repeated twice.

In footnote 25 to paragraph 71, the word *instruments* should be changed to *statements*.