Exposure Draft ED/2015/8: IFRS Practice Statement: Application of Materiality to Financial Statements

Dear Hans,

Mazars welcomes the opportunity to comment on the International Accounting Standards Board’s Exposure Draft (hereafter ED) IFRS Practice Statement: Application of Materiality to Financial Statements, issued on 28 October 2015.

We welcome the objective of this draft IFRS Practice Statement of providing additional guidance as regards the assessment of materiality. We agree with the IASB that such guidance is needed and therefore that it would be useful to publish it in advance of the Principles of Disclosure (POD) project, even if the POD project may reconsider the definition of materiality. In our view, a number of the aspects linked to materiality in the draft practice statement will most probably remain valid regardless of a change in the definition.

We agree with the non-mandatory status of this document and that it is better positioned as a Practice Statement. We do not consider that such status and positioning would undermine its importance and relevance.

Whilst we welcome the IASB’s initiative and acknowledge that producing useful guidance on this subject is a difficult task, we consider that it needs more work.

We note that the document makes some reference to other areas where, within the field of financial reporting, materiality is applied as a concept such as financial regulation (as mentioned in paragraph 5), but also auditing, which is only referred to in the Basis for Conclusions (BC 18-20). We regret that such references are very limited: we would find it more helpful if the document promoted a common understanding of the role and application of materiality in IFRS amongst all the stakeholders, instead of being addressed only to management. Our practical experience indicates that there is often a common understanding of the role and application of materiality amongst preparers and auditors whilst regulators and users more often than not have a different understanding. To this effect, the discussion on users’ characteristics and the decisions they make is useful and could even warrant inclusion in the Conceptual Framework. However, in order to foster such common understanding amongst the various parties to the financial reporting chain, we would welcome the IASB undertaking more outreach activities, consulting more widely with stakeholders, including auditors and regulators, as well as management, before it issues the final document.
We think the main merit of the draft practice statement is to usefully centralise aspects linked to materiality which are addressed in the Conceptual Framework and individual IFRSs, to provide a link between these aspects and to illustrate them with practical aspects to take into consideration when assessing materiality.

This, in our view, is a good starting point but we are concerned that it will probably not be helpful enough to change behaviour.

The document would be more effective if it were more concise and more “to the point”, by actually applying what it recommends to its own structure and content. In this respect, it could be useful to articulate the discussion in terms of the process to follow in making decisions on materiality, including mentioning the necessary data collection required to make informed and reliable decisions. We formulate some proposals as regards the structure and content of the document in our answer to question 3. These proposals include the deletion of the section on omissions and misstatements which, since these terms are part of the definition, should only be discussed in the context of whether they are material or not, following the decision process we mention above.

In addition, the examples included in the document are rather simplistic and/or general. To enhance their effectiveness, they could be improved by providing more background, context and explanation on following the process to guide the reader to the outcome of whether the information is material or not, and when it is, where and how it should be presented. Suggestions in this respect are made in our answer to question 2.

In terms of readability of the document, we suggest that the IASB could depart from its usual document formatting aspects and be inspired by publications issued by other parties on disclosures (e.g., amongst others UK FRC, French AMF and CPA Canada).

To sum up, we encourage the IASB to consult more widely with all stakeholders in the financial chain to promote a common understanding and to give more focus and guidance on the decision-making process related to materiality in order to make the document truly effective in changing behaviour.

Our detailed comments to the questions raised in the Request for Views are set out in the Appendix.

Please do not hesitate to contact us should you want to discuss any aspect of our comment letter.

Yours sincerely,

Michel Barbet-Massin

Head of Financial Reporting Technical Support
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? Why or why not?

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?

We agree with the non-mandatory status of this document and that it is better positioned as a Practice Statement since it draws on materiality-related discussions coming from different sources within IFRS (Conceptual Framework and standards) and cannot therefore be specifically attached to one single text. We do not consider that such status and positioning would undermine its importance and relevance to all stakeholders.

We note however that some aspects discussed on the characteristics of users and the decisions they make could usefully be included in the Conceptual Framework itself.

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.

We find the examples rather simplistic and/or general and therefore not as effective as they could be. We consider that the examples could be improved by providing more background, context and explanation on following the process to guide the reader to the outcome of whether the information is material or not, and when it is, where and how it should be presented.

Enhancing the usefulness of the examples proposed by being more specific and providing more context

In particular, we do not think the examples provide enough context to enable a decision about whether or not inclusion of information is necessary on the grounds of materiality. For instance, the example at the end of paragraph 53(a), is, in our view, not an example in the true sense as it merely repeats generalities and does not serve as an illustration: “management should provide other information about property, plant and equipment, even if not specifically required by IFRS, if that information could reasonably be expected to influence decisions that the primary users make on the basis of the financial statements” (emphasis added). It would be more useful in our view to provide an example of such information as well as of how and why it can reasonably be expected to influence primary users’ decisions.
We also think that the practice statement could provide examples of information that could be omitted and suggest that the example of the smaller pension plans in paragraph 53(b) could be one such example, contrary to what is being proposed (disclosing of only the key risks and sensitivities).

Given the requirements of IFRS 8 which are to provide the information which is provided to the Chief Operating Decision Maker, we are not sure we understand how much leeway the draft practice statement suggests there is in terms of materiality of the information provided on segment reporting in paragraph 53(d). This particular example, should in our view, be further detailed so as to illustrate the point.

In terms of aggregation or rather, disaggregation, of information, we consider that the practice statement could benefit from including the following examples to illustrate paragraph 38:

- When disaggregation of an item results in a significant amount (comparative to the item as whole and/or to the other amounts resulting from the disaggregation) which is labelled ‘others’, some form of narrative disclosure would generally be warranted.
- Narrative information on year-end balances of the statement of financial position could also be necessary to satisfy materiality in the context of the relevance of financial information, rather than just providing an explanation on the significant movements which occurred during the reporting period.

**Considering examples available in other areas linked to financial reporting such as ISAs**

In terms of the benchmarks described in paragraph 22, we think these could be illustrated by items described in ISA 320.A3 (for instance on the entity’s ownership structure or on the provision of R&D information in the pharmaceutical industry) and .A10 on laws and regulations (for instance related party, remuneration of management and of those charged with governance).

Paragraph 27, on examples in which considering quantitative aspects may not be helpful when making assessments about materiality, could be expanded with examples on the indexation of management’s remuneration to net income or to the stock price (ISA 450.A16 – in the context of misstatements).

We are concerned that the offsetting of misstatements addressed in paragraph 72 – which we propose to delete – is in contradiction with ISA 450.A14 which considers offsetting of misstatements solely in the context of an account balance or a class of transactions. We do not think it is relevant in this practice statement to mention offsetting of immaterial misstatements relating to different items.

**Examples to reflect the proposed change to the objective of financial statements**

Finally, keeping in mind that the proposed objective of financial statements (in the Conceptual Framework 2015 ED) includes the assessment of stewardship, we consider that the draft practice statement should incorporate examples relating to this objective also.
**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?
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?
c) Are there any paragraphs/sections with which you do not agree? If so, which paragraphs/sections 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 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?

(a) to (d)

We consider the document would be more effective if it were more concise and more “to the point”, by applying what it recommends to its own structure and content. In this respect, it could be useful to articulate the discussion in terms of the process to follow in making decisions on materiality, including mentioning the necessary data collection required to make informed and reliable decisions. In terms of format, we suggest that, to enhance the document’s readability, the IASB could depart from its usual document formatting aspects and be inspired by publications issued by other parties on disclosures (e.g., amongst others UK FRC, French AMF and CPA Canada).

We would recommend a structure articulated along the following main topics:

1. Objective
2. Scope
3. Definition
4. Context of the materiality assessment
5. General characteristics of materiality
6. Applying materiality to recognition and measurement of elements of financial statements
7. Applying materiality to presentation and disclosures in the financial statements

Such a structure would, in our view, avoid repetitions and make it easier for the discussion and examples included in sections 6 and 7 on application of materiality to be articulated by reference to sections 4 and 5.
We would recommend that, similar to IFRSs, a table of contents of the practice statement be presented. We explain hereafter the aspects we think ought to be addressed in these sections.

1. Objective
We note that the document makes some reference to other areas where, within the field of financial reporting, materiality is applied as a concept such as financial regulation (as mentioned in paragraph 5), but also auditing, which is only referred to in the Basis for Conclusions (BC 18-20). We regret that such references are very limited: we would find it more helpful if the document promoted a common understanding of the role and application of materiality in IFRS amongst all the stakeholders, instead of being addressed to management. Our practical experience indicates that there is often a common understanding of the role and application of materiality amongst preparers and auditors whilst regulators and users more often than not have a different understanding. To this effect, the discussion on users’ characteristics and the decisions they make is useful and could even warrant inclusion in the Conceptual Framework. However, in order to foster such common understanding amongst the various parties to the financial reporting chain, we would welcome the IASB undertaking more outreach activities, consulting more widely with stakeholders, including auditors and regulators, as well as management, before it issues the final document.

2. Scope
We think this section could be expanded to explain the difference made between primary financial statements and the notes, rather than doing it in a footnote.

3. Definition
This section would include most of the discussion in paragraphs 7 to 10 but also refer to section 4 for the context of the materiality assessment (regarding the users), to section 5 on general characteristics (entity-specificity, nature and magnitude) and define the notions of omissions and misstatements, which are part of the definition.
We note that the notion of misstatement is not defined in IFRS and would suggest that the IASB consider the definition and descriptions included in ISA 450.4(a) and .A1 to enhance the discussion on these aspects. This may, however, need to be considered for inclusion in IAS 8.
In addition we think the discussion could also make more reference to the discussions included in sections 4 and 5 to illustrate the assessment of whether a misstatement is material or not.

4. Context of the materiality assessment
In this section we would expect the following to be discussed:
- The objective of financial statements, having regard to the fact that references to the Framework may need to be amended, with specific consideration of annual versus interim reporting;
- Users of financial statements and their decisions, based on the proposed discussion on characteristics of the primary users of financial statements and the decisions made by the primary users of financial statements.
We consider that some aspects of the discussion on users may warrant being included within the Framework itself; and

- References to the wider context of other areas within financial reporting where the materiality concept is applied such as legal/regulatory requirements (mentioned in paragraphs 5-6) and audit requirements (which are solely mentioned in BC 18-20).

5. General characteristics of materiality
We think this section should be articulated around the following general characteristics: pervasiveness, entity-specificity, judgement (including uncertainties), qualitative and quantitative assessment, individual and collective assessment, time sensitivity.

6. Applying materiality to recognition and measurement of elements of financial statements
Because materiality is in general considered in the context of presentation and disclosures, we think that to reinforce its character of pervasiveness to recognition and measurement, discussion on these aspects is better placed prior to the discussion on presentation and disclosures. In addition, this follows the sequence of the process of reporting financial information, which is also the way IFRSs are written.

In terms of the content of this section, before talking about practical expedients, we think that the point should be made that, in order to assess materiality, all the related information needs to be collected (under a heading labelled ‘exhaustivity’) and that materiality does not apply to whether or not an element is recognised but to where, how and for how much.

7. Applying materiality to presentation and disclosures in the financial statements
In this section, we think most of the existing wording could remain but that it could usefully be rearticulated in the following sequence:

- Presentation and disclosure requirements in IFRS;
- Aggregation and disaggregation of information; and
- Placement of information: primary financial statements vs the notes.

In terms of the placement of information, we consider that it should be made clear that the objective of the notes is not to compensate for information which should have been included, according to IFRS, in the primary financial statements.

Omissions and misstatements
We consider that the whole section on omissions and misstatements should be deleted, except for aspects articulating them in the context of the materiality assessment, as both these notions are part of the definition.

In particular, we consider that aspects related to governance, such as fraud, internal controls and intentional misstatements are not relevant to the discussion on materiality in this Practice Statement which topic is to help determine whether information, and therefore whether omission or misstatement of information, is material or not.
(e) Potential conflicts with legal requirements relating to materiality
We are unaware of potential conflicts with legal requirements relating to materiality as described in the draft practice statement. We are nonetheless of the view that this guidance should remain non mandatory, should such conflicts exist in practice currently or in the future. As mentioned in our response to question 1, we do not think such status will undermine its importance and relevance.

**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?

Given that the Principles of Disclosure project is at the stage of an upcoming Discussion Paper, we agree that it is more important for the IASB’s constituents to finalise this draft Practice Statement, at the risk of subsequent modifications, than to wait a number of years for the other projects in the Disclosure Initiative to be completed. In addition, we agree with the IASB that any changes to the definition of materiality would probably have little bearing on the general discussion of the characteristics and the factors that are to be considered when assessing materiality as well as on how to apply the concept.

As previously mentioned, changes to the proposals could also occur depending on the finalisation of the Conceptual Framework, as some aspects discussed in this document explicitly incorporate references to the Conceptual Framework that the 2015 Exposure Draft is proposing to change.
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.

Paragraph 23
We are not sure we understand the point that the document is trying to make in the following sentence: “the focus of the materiality assessment is whether the information ‘could reasonably be expected to influence’ decisions made by users rather than whether that piece of information alone is capable of changing their decisions” (emphasis added).
We do not think the two parts of the sentence are in opposition. Moreover, the rest of the paragraph does not, in our view, provide an understandable explanation.

Costs to management
BC 23 states that “the expected effect of the proposed guidance is a better understanding and application of materiality without any significant costs for management”.
We are not convinced by the statement on non-significant costs for management. We note that, in order to make informed and reliable decisions on materiality, all the data still needs to be collected. As previously mentioned, we think this point should be explicitly referred to in the guidance. In addition, the review, at each reporting date, and the analysis of the data collected, to determine whether information is material or not and then to determine how to present and disclose material information, as well as the decision to remove immaterial information is time consuming and therefore costly for senior management.
We think that not acknowledging that fact is not helpful if the objective is to change behaviour by moving away from the “disclosure-checklist” mentality and framework.