



OBSERVATIONS ON MATERIALITY IN FINANCIAL REPORTING

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Introduction

The primary objective of financial statements is to provide useful information to a wide range of users for the purposes of economic decision-making. To be useful, such statements must present fairly¹ the financial position, performance and cash flows of the reporting entity. Where information which is required by the relevant financial reporting framework is omitted or misstated, and such information could influence the economic decision-making of a user, financial statements cannot be said to achieve a fair presentation. The concept of '*materiality*' is used to describe such information.

Thus, the application of the concept of materiality is of critical importance in the context of the preparation of financial statements. It impacts on many decisions such as how an entity should recognise, measure, and disclose specific transactions and information in the financial statements, whether misstatements require correction and whether assets and liabilities or items of income or expense should be separately presented.

Why is this paper being issued?

This paper is being issued to provide interested parties with an overview of the requirements of IFRS² with respect to the assessment of the materiality of omissions or misstatements and to outline the Irish Auditing and Accounting Supervisory Authority's ('IAASA') observations arising from its engagement with issuers in respect of their materiality judgements. IAASA's interactions with issuers to date have demonstrated that the assessment of materiality can be unduly focused on a narrow range of quantitative considerations, as well as on the needs of a limited range of users. This paper aims to assist preparers with materiality assessments in respect of their financial reports as well as to provide preparers who may become subject to IAASA's supervisory activities with an understanding of its likely approach³.

Who should read this paper?

This paper is designed to be of interest to:

- entities who prepare their financial statements under IFRS and, in particular, those who come within IAASA's financial reporting review remit;
- the auditors of such entities; and
- other parties who have a particular interest in the concept of materiality and the application of same in an IFRS context.

It is hoped that, by providing its observations on the subject of materiality, entities under IAASA's supervisory remit will be better informed of its areas of concern and thereby be better equipped to respond more appropriately to IAASA's information requests.

¹ IFRS requires that financial statements shall 'present fairly'. The Transparency Directive (2004/109/EC) Regulations 2007 require that those responsible within an issuer present a statement to the effect that the financial statements show 'a true and fair view'. These requirements are viewed as different articulations of the same concept (see Legal Opinion 'The True and Fair Requirement Revisited', published by the FRC).

² International Financial Reporting Standards

³ Readers may find it useful to note that where, following its review of an issuer's financial report, IAASA concludes that it is necessary to initiate correspondence with that issuer, IAASA corresponds with the issuer's directors, given their duty under company law to prepare the financial statements in accordance with IFRS.

Key observations

- Assessment of the materiality of an item is primarily a judgemental process requiring evaluation of whether particular information could influence users' economic decisions;
- Users of financial reports include investors, employees, lenders, suppliers, customers, regulators and other Government agencies and the public and preparers must give consideration to a wide range of user needs in evaluating the necessary disclosures⁴. Preparers should ensure that undue focus is not placed on investors' needs, to the exclusion of other interested parties;
- Materiality assessments are not determined by a simple quantitative comparison to primary financial statement totals but rather encompass evaluation of a range of factors, for example, amounts which are relatively insignificant in comparison with the overall results of the entity may nonetheless be highly qualitatively material to a user;
- Materiality thresholds are specific to an individual issuer and to particular items, and may vary from year to year, according to the circumstances; and
- The circumstances surrounding a preparer's decision not to correct an identified and easily corrected error requires careful consideration in the context of a materiality judgement.

Discussion

What does IFRS provide?

Reflecting its importance to the financial reporting process, IFRS make several references to the application of the concept of materiality as follows:

- the term '*material*' is defined in the following way:

'Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.' (IAS 1, paragraph 7)
- financial statements do not comply with IFRS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows (IAS 8, paragraph 41);
- it is inappropriate to make, or leave uncorrected, immaterial departures from IFRS to achieve a particular presentation of an entity's financial position, financial performance or cash flows (IAS 8, paragraph 8);
- material classes of similar items are presented separately, while items of a dissimilar nature or function are presented separately unless immaterial (IAS 1, paragraph 29);
- items which are not sufficiently material to warrant separate presentation in the financial statements may warrant separate presentation in the notes (IAS 1, paragraph 30);
- accounting policies set out in IFRS do not need to be applied where the effect of applying them is immaterial (IAS 8, paragraph 8);
- specific IFRS disclosures are not required where the information is not material (IAS 1, paragraph 31); and
- materiality provides a threshold or cut-off point rather than a primary qualitative characteristic which information must have if it is to be useful (Framework, paragraph 30).

⁴ See paragraph 9 of the IASB's Framework for the Preparation and Presentation of Financial Statements for a discussion of users and their information needs.

What are the practical implications?

An assessment of materiality requires the preparer to understand the types of users of its financial reports, the attributes of the information which may trigger materiality considerations as well as the purpose of the disclosure. IAASA's key observations arising from its experience of issuers' approaches to materiality judgements are outlined below.

Users

- Since the assessment of materiality requires evaluation of whether particular information could influence users' economic decisions, an understanding of the nature of the users of an entity's financial report and the kind of economic decisions they make is necessary. There are many stakeholders with an interest in an entity's financial reports, including current and potential investors, employees, lenders, suppliers, customers, regulators and other Government agencies and the public. The Framework acknowledges that financial reports cannot satisfy all of the needs of the various user groups and notes that providing information for investors will generally satisfy the needs of other groups. Nonetheless, preparers need to give consideration to the particular user groups that have an interest in their financial reports and evaluate whether there are particular information requirements to be met. In particular, preparers should ensure that undue focus is not placed on investors' needs to the exclusion of other users. This is particularly the case given current economic and market conditions, whereby a wider range of users are now likely to be interested in information contained in financial reports, especially those of financial institutions.
- It is also of note that the assessment of materiality involves consideration of whether an omission or misstatement '*...could...influence the economic decisions that users make...*' [bold emphasis added]. Thus, the information does not have to change a decision, but rather it must merely have the capacity to influence it. For example, having considered additional relevant information, a user may not alter a decision, although in different circumstances, such information could have changed the decision. Moreover, a particular piece of information may lend further support to information or trends already evident in the financial statements and thus reinforce the user's decision.
- The types of decisions that users make and the kind of information that may be relevant to those decisions also require consideration in the context of the evaluation of an omission or misstatement. For example, financial statements would normally be expected to provide information that is relevant to assessments regarding:
 - whether to acquire, hold or dispose of an entity's securities (investors);
 - the ability of the entity to provide remuneration and retirement benefits (present and past employees);
 - whether to extend credit to the entity (lenders);
 - whether amounts owed are likely to be paid and whether to continue to supply goods and/or services to the entity (creditors); and
 - the entity's compliance with certain regulatory requirements (regulators).

Attributes of the information

- Together with considerations about the particular range of users and their decision-making needs, the assessment of whether information could influence a user will clearly depend on the attributes of the information concerned. The IASB definition of the term '*material*' highlights the particular attributes of size and nature, and specifies that items should be judged in the particular circumstances of their omission or misstatement. In other words, both quantitative and qualitative factors are relevant to materiality assessments.
- Thus, while quantitative thresholds often form part of a materiality assessment, the materiality of an item is not determined solely by a simple quantitative comparison to primary statement totals, nor can an overall materiality threshold applying across all transactions and balances be numerically defined. Moreover, a materiality threshold will not be constant either within the same entity over time, or across entities.
- The nature of, and the circumstances surrounding, an item will vary and each entity will decide according to its own particular circumstances. Examples of common factors to which materiality judgements are usually particularly sensitive include, amongst others:
 - corporate governance failures;
 - breaches of legal and/or regulatory requirements;
 - transactions with directors; and
 - an unusual or non-recurring transaction (or transactions).

Indeed, in respect of such factors, it may be the case that, having regard to the nature or circumstances of an item, information which does not impact on the amounts recognised in the financial statements is nonetheless critical to a user's assessment of the entity's future prospects.

Purpose of the disclosure

- Moreover, the purpose of the disclosure can impact on the materiality threshold. For example, users may study information in financial reports for the purposes of evaluating the stewardship and accountability of those entrusted to manage the entity. An element of that evaluation will entail a review of financial and non-financial information, including details of directors' remuneration as well as other relevant related party information. While the amounts involved are often small in comparison with the overall results or net assets of the entity, such disclosures may nonetheless be highly qualitatively material to a user seeking to assess the performance of management and the appropriateness of their continued stewardship of the entity.

Intentional errors

- During the periodic financial reporting process, there is potential for the manipulation of the materiality concept in order to achieve a particular presentation of an entity's financial position, financial performance or cash flows by intentionally leaving errors uncorrected on the grounds that they are not material. IFRS does not permit such intentional errors to remain uncorrected, even where they have been assessed by the entity as immaterial. Commonly quoted examples of where apparently immaterial errors can have material impact include where an error results in a reversal of a trend - for example, a loss being turned into a profit or *vice versa* - or where it impacts on ratios or other metrics used to evaluate, for example, debt covenant breaches. Moreover, the set-off of compensating error amounts does not transform material misstatements into immaterial misstatements, particularly where such items do not appear in the same line item or subtotal amount, or where they, on their own, would relate to transactions meriting separate disclosure.

Closing remarks

Ultimately, the decision as to whether an item is material is a matter of judgement for the preparers of the financial statements, such judgements being made with the benefit of their detailed knowledge of the entity and the nature and circumstances surrounding the item, considered in the context of the objective, and requirements of the relevant financial reporting standard(s).

Issuers' directors with whom IAASA engages on the subject of materiality judgements should continue to expect that these matters will be thoroughly probed with a view to enabling IAASA to assess the adequacy and appropriateness of those judgements.

Specifically, issuers can continue to expect to be required to address enquiries as to:

- how the range of users of the issuer's financial reports have been considered and factored into judgements made; and
- the quantitative and qualitative elements which have been incorporated into their materiality judgements.

Similarly, where issuers are unable to demonstrate that, where applicable, their materiality judgements have had regard to these considerations, they should expect detailed and robust engagement on any consequential implications for their financial reports. In that context, and with a view to ensuring that they are best placed to respond to such enquiries, issuers (and, in particular, issuers' Boards and Audit Committees) may find it useful to consider formally documenting their approach to, and the rationale underpinning, their materiality assessments.

Further information

For further information about IAASA, please visit IAASA's website at www.iaasa.ie or alternatively contact:

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MATERIALITY REFERENCES IN IFRS**The Framework***“Materiality*

29 *The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.*

30 *Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.”*

IAS 1*“Materiality and aggregation*

29 *An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.*

30 *Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.*

31 *An entity need not provide a specific disclosure required by an IFRS if the information is not material.”*

IAS 8

“8 IFRSs set out accounting policies that the IASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRSs to achieve a particular presentation of an entity's financial position, financial performance or cash flows.”

“41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.”