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27 January 2016

Dear Roger

Thank you for providing the Financial Reporting Council (FRC) with the opportunity to comment on your draft comment letter to the IASB on the Exposure Draft ED/2015/8 IFRS Practice Statement: *Application of Materiality to Financial Statements* (PS). We have included our response to the IASB for your information.

Like EFRAG, we welcome the IASB's decision to issue guidance on the application of materiality. Such guidance has the potential to be a catalyst for improvements in the quality and relevance of disclosures in IFRS financial statements and could help to stimulate behavioural change.

We set out some further points below for EFRAG to consider including in its draft comment letter. Detailed responses to EFRAG's questions to constituents are included in the appendix to this letter.

Thought process for applying materiality

In paragraph 23, EFRAG suggests steps that preparers could follow when applying materiality. We set out similar steps to the thought process in our response to the IASB and we agree with EFRAG that the PS will be far more useful if it focuses on how to apply such a thought process in practice, illustrating this with example scenarios. We suggest that EFRAG includes a final step: that preparers step back and review the financial statements as a whole, ensuring that information is given prominence relative to its importance.

Prominence of information

In the section of EFRAG's letter that discusses prominence (paragraphs 27-32), we believe it would be helpful to highlight how the application of materiality is different in the context of the primary financial statements (where it is partly a matter of the level of aggregation or

disaggregation) and the notes (where it is a matter of whether to omit or include additional information and judging the appropriate level of detail).

Intentional misstatements

In our view the discussion in paragraphs 77 to 79 of the PS on intentional misstatements is confusing. In our letter to the IASB, we emphasise that intentional misstatements should not automatically be considered material merely because they are deliberate. However, an error, whether intentional or not, might be considered immaterial in isolation yet still be material because of its impact on the overall results or presentation in the financial statements. We recommend the IASB expands the example in paragraph 79 so as to include the situation where a company decides not to apply the appropriate discount rate to a liability because it has determined that the difference in the measurement of the liability that would result from updating the discount rate would not be material. In such a case the deliberate misstatement should not be considered material.

Terminology

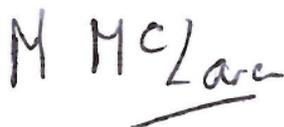
We believe that the PS provides an opportunity for the IASB to clarify the meaning of the various terms used to refer to materiality (for example: 'key', 'principal' and 'significant'). Our letter to the IASB suggests that it considers revising IFRS literature to ensure that these terms are used consistently, making any hierarchical relationship between them clear.

Timing

Like EFRAG, we support the IASB's decision to issue the PS before the completion of the Principles of Disclosure (PoD) project. However, should the PS require re-exposure, this should not be done at the cost of diverting resources that could delay the next step in the PoD project, namely the publication of a Discussion Paper.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

A handwritten signature in black ink that reads "M McLaren". The signature is written in a cursive style with a horizontal line underneath the name.

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Appendix – Detailed responses to questions for constituents

9. Do you agree that the guidance should be issued in the non-mandatory form of a Practice Statement? If not, please explain your preferred form. If so, please explain how you believe a non-mandatory practice statement may result in positive changes in behaviour.
10. Do you consider that the specific aspects of the proposed content of the guidance may cause enforcement issue or conflict with local regulations? Please specify which aspect, if any.

Yes, we agree that it is appropriate to issue the guidance as a non-mandatory Practice Statement because the application of materiality requires professional judgement on the specific facts and circumstances and because, in some jurisdictions, there are legal or regulatory requirements for the application of materiality.

The aim of the PS is to assist with the application of the concept of materiality, not to set new requirements or amend the definition of materiality, therefore non-mandatory guidance is appropriate. Furthermore, materiality is a pervasive concept so issuing a Practice Statement setting out overarching guidance is more logical than locating this content in a particular Standard.

In our view, if the PS should be re-drafted to be more practical, focusing on the thought process that preparers and others could follow when applying the concept to various scenarios, it is likely to be effective in encouraging behavioural change. We understand that it can be difficult to make materiality judgements and that, in some cases, there is a reluctance to remove immaterial information from financial statements, so additional guidance in this area will be useful.

We do not envisage that the guidance will cause conflicts with legal requirements in the UK. The PS is consistent with the existing UK reporting framework and company law and, in any case, is non-mandatory.

17. Do you agree that the inclusion of illustrative examples in the Practice Statement is helpful? If not, please explain.
18. Do you agree with EFRAG's assessment that illustrative examples should focus on the areas discussed in Paragraph 13 above?
19. Do you believe that the illustrative examples currently included in the draft Practice Statement could have any unintended consequences or counter-productive effects? If so, please explain.

Yes, we agree that the inclusion of illustrative examples in the PS is helpful. We believe that the examples in the PS provide a good starting point, but should be expanded. In our letter to the IASB we suggest that the IASB gathers examples from preparers of how they have made challenging materiality judgements in practice and uses these as a basis for the examples in the PS. We agree with the areas of focus set out by EFRAG in paragraph 13 of its draft comment letter and discuss these points in some detail in our response to the IASB.

In our view, each example in the PS should explain clearly the factors that were considered, the thought process that was followed and how the conclusion was reached, providing practical guidance on how to apply materiality in each scenario. To avoid unintended consequences, the examples need to be specific and provide a sufficiently detailed description of the particular circumstances, to reduce the risk that the conclusions in the examples are extrapolated to situations where this may not be appropriate.

44. Do you agree that the draft Practice Statement should primarily provide guidance on the topics identified in paragraphs 25 to 43? If not, please explain which other topics should be covered.

Yes, we agree that the PS should focus on the topics identified in paragraphs 25 to 43 of EFRAG's draft comment letter. In our covering letter to EFRAG we have also set out some additional areas that we believe it should provide guidance on.

51. Do you have any other comments on the draft Practice Statement or on EFRAG's draft comment letter?

Paragraph 39 of EFRAG's draft comment letter summarises the section of the PS that discusses immaterial information. In our view, paragraph 39(b) of EFRAG's letter may inadvertently misrepresent the content of paragraph 36 of the PS, which states that the fact that something is not a material issue for an entity may be material information that should be disclosed, rather than stating that there is a need to disclose immaterial information.

Ms Kristy Robinson
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27 January 2016

Dear Kristy

This letter sets out the comments of the UK Financial Reporting Council (FRC) on the Exposure Draft ED/2015/8 IFRS Practice Statement: *Application of Materiality to Financial Statements* (PS). Our main comments on the PS are set out below and our answers to the consultation questions are included in the appendix.

We welcome the IASB's decision to issue guidance on the application of materiality. Such guidance has the potential to be a catalyst for improvements in the quality and relevance of disclosure in IFRS financial statements. We recognise that it can be difficult to make materiality judgements and that, in some cases, there is a reluctance to remove immaterial information from the financial statements. We believe that guidance in this area could help stimulate behavioural change.

However, we are concerned that in its current form the PS will not meet its objectives and bring about the changes in behaviour and improvements in the quality and relevance of disclosures that are envisaged and intended. To do so, the PS would need to be significantly more practical in approach, more accessible to the intended audience and provide guidance on additional matters with greater focus on the application of materiality to disclosures. We consider areas for improvements below and in the appendix. Addressing these issues may require a re-exposure of the PS. That said, the current draft is a useful summary of existing IFRS literature on the concept of materiality and could be made available as educational material, to supplement the redrafted PS.

The process for applying materiality

We believe that the PS will be more successful in changing behaviour if it provides practical guidance rather than reiterating and explaining the concept of materiality set out in existing IFRS literature. We suggest cross-referencing this reference material in the PS where necessary so that the PS is more focused and concise.

We recommend that the PS focuses instead on the thought processes and steps that preparers could follow when making materiality judgements and illustrates this with more detailed examples demonstrating how companies have applied this process in practice in a variety of scenarios. We set out a broad outline of this thought process in the appendix to this letter. It would be helpful for the examples in the PS to focus more on the notes to the financial statements where the application of materiality is generally more difficult and judgemental.

Content of the Practice Statement

In our view there are a number of areas where applying materiality is particularly challenging and it would be helpful for the PS to provide more guidance:

- how the qualitative aspect of materiality is applied in practice, highlighting the types of scenarios where qualitative factors should be given more weight than the quantitative factors;
- more illustrative examples showing the difference between how materiality is applied in the context of the primary financial statements (in particular with respect to the level of aggregation or disaggregation) and in the context of the notes (where it is a matter of whether to omit or include information, and judging the appropriate level of detail);
- how preparers should assess whether the most important information has been given sufficient prominence and how to avoid obscuring material information;
- how to determine how much detail should be provided in non-numerical disclosures and whether that information is immaterial and can be omitted entirely;
- how the need to assess management's stewardship affects materiality judgements;
- clarify the position on intentional misstatements;
- how materiality should be applied to significant assumptions, estimates and uncertainties;
- how materiality should be applied to interim financial reporting; and
- clarification of the relationship between the various terms that are used to refer to materiality (for example: 'key', 'principal' and 'significant').

We discuss these matters in more detail in the appendix to this letter.

Audience of the Practice Statement

While the primary audience of the PS is preparers, in our view it is likely to have more impact if it also addresses other stakeholders such as auditors, regulators and enforcers because their policies and procedures affect the materiality judgements of preparers. Investors may also be interested to understand more about how materiality judgements are made in practice.

Form of the guidance

We agree with the IASB that a Practice Statement is an appropriate form for the guidance. In our view, it would be difficult for the IASB to mandate guidance on materiality because it requires the application of professional judgement to specific facts and circumstances and because in some jurisdictions there are legal or regulatory requirements for the application of materiality.

The aim of the PS is to assist with application of the concept of materiality, not to set new requirements or amend the definition of materiality, therefore non-mandatory guidance is appropriate. Furthermore, materiality is a pervasive concept so issuing a Practice Statement setting out overarching guidance is more logical than locating this content in a particular Standard.

Timing for issuing the Practice Statement

The ED notes that the IASB intends to issue the PS before the finalisation of its Principles of Disclosure (PoD) project. In our view, appropriate application of materiality is crucial to improving the usefulness and relevance of financial statements. Therefore, we welcome the IASB's decision not to delay issuing the guidance until the PoD project is completed, on the basis that the IASB will consider the need for consequential amendments to the PS once the PoD project and revisions to the Conceptual Framework are complete.

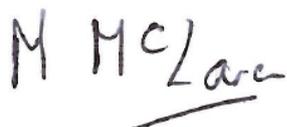
However, should the PS require re-exposure we are concerned that this may divert resources from the PoD Discussion Paper delaying its publication even further. Given the importance of the PoD project to the entire Disclosure Initiative (DI) we urge the IASB to ensure the PoD Discussion Paper is given priority over any required re-exposure of this Practice Statement.

Collaboration with other organisations

We encourage the IASB to collaborate with other organisations that issue guidance on the application of materiality, including continuing to collaborate with the International Auditing and Assurance Standards Board (IAASB), to ensure that a consistent approach is adopted.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

A handwritten signature in black ink that reads "M McLaren". The signature is written in a cursive style with a horizontal line underneath the name.

Melanie McLaren
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Appendix – Detailed responses to consultation 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) 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?

Yes. As noted in our cover letter, we believe that the guidance should be non-mandatory and that a Practice Statement is an appropriate form for the guidance.

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.

Yes, we think that the inclusion of additional examples would be helpful. We believe that the examples in the PS provide a good starting point, but should be expanded. We suggest that the IASB gathers examples from preparers illustrating how they have made challenging materiality judgements in practice and uses these as a basis for the examples in the PS.

In our view, each example in the PS should explain clearly the factors that were considered, the thought process that was followed and how the conclusion was reached, providing practical guidance on how to apply materiality in a variety of scenarios. To avoid unintended consequences, the examples need to be specific and provide a sufficiently detailed description of the particular circumstances, to reduce the risk that the conclusions in the examples are extrapolated to situations where this may not be appropriate.

In our response to Question 3 we set out the steps we think preparers could follow when applying materiality. We also highlight specific areas in which we believe materiality judgements are particularly challenging and it would be helpful for the PS to provide more guidance and examples.

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?

The process for applying materiality

As noted in our covering letter, we believe that the PS will be more effective at changing behaviour if it focuses on providing practical guidance on the application of materiality rather than primarily explaining the concept and definition of materiality.

With this in mind, we believe it would be helpful for the PS to explain the steps of the thought process that preparers could follow when making materiality judgements. In our view these steps are to:

1. consider the profile of the primary users of the company's financial statements and their information needs;
2. consider the appropriate level of aggregation in the primary financial statements, ensuring that line items are presented at an appropriate level of granularity;
3. determine which of the disclosure requirements in the Standards that are relevant to the company's business, and what (if any) additional information that is not specifically required by a Standard, could influence the decisions of the primary users or their assessment of management's stewardship, given the particular circumstances of the company;

4. consider the appropriate level of detail and explanation to provide in each disclosure to communicate the information clearly while ensuring that material information is not obscured; and
5. step back and review the financial statements as a whole, ensuring that each piece of information presented or disclosed is given appropriate emphasis and prominence, relative to its importance (considering its nature, the likelihood of occurrence, its magnitude and the time frame of effects).

We suggest that the IASB uses these steps as a basis for the examples in the PS, explaining how preparers followed the steps and reached their conclusion in each case. We note that International Integrated Reporting Council's recent publication *Materiality in <IR>*—although broader in scope than the IASB's PS—sets out factors for companies to consider when applying materiality and includes examples demonstrating how companies have done so in practice. Redrafting the PS using a similar structure may make it more practical.

Content of the Practice Statement

Below we set out several areas where we believe the application of materiality is particularly challenging and more guidance in the PS would be helpful.

Qualitative materiality judgements

In our view, the PS should include more discussion and examples of how to make qualitative materiality judgements and how qualitative factors interact with quantitative ones in various circumstances. For example, the weight given to qualitative factors may increase when:

- an issue is particularly relevant to assessing management's stewardship of the entity's resources;
- considering what information is relevant to an understanding of management remuneration or related party transactions;
- a matter has had little financial impact in the current period but may do so in future years, (such as when the matter may constitute a significant reputational risk); and/or
- applying materiality to non-numerical information.

Applying materiality to the notes and considering the prominence of information

We believe it would be helpful for the PS to explain how preparers make the assessment of whether information has been given sufficient prominence. The PS should explain how preparers can determine whether information should be presented as a separate line item or aggregated with other information in the primary financial statements, and whether additional disclosure in the notes should be provided.

We welcome paragraph 46 of the PS, which explains that materiality applies differently in the context of the primary financial statements and the notes because they have different purposes. In our view, this section of the PS should be expanded to explain in more detail how preparers can determine the appropriate location for information and highlight the difference between how materiality applies in each context; when applied to the primary financial statements materiality impacts on the level of aggregation or disaggregation whereas in the

context of the notes it is a matter of whether to omit or include information and judging the appropriate level of detail.

The majority of the difficulties in applying materiality relate to the notes to the financial statements rather than the primary financial statements, so it would be helpful for the PS to provide more specific guidance relating to the notes. The PS could include guidance on how companies should determine the appropriate level of detail to provide in the notes in a variety of scenarios, including examples of how companies have determined in practice that certain information is immaterial and can be omitted from the notes entirely.

In particular, it is important that the PS emphasises that an entity need not provide a specific disclosure required by a Standard if the information resulting from that disclosure is not material, as noted in paragraph 31 of IAS 1 *Presentation of Financial Statements* (IAS 1). For example, the recent research the New Zealand Accounting Standards Board (NZASB) contributed to the IASB's DI highlighted that when property, plant and equipment is a material line item in the primary financial statements it does not automatically follow that all of the disclosure requirements in IAS 16 *Property, Plant and Equipment* will provide material information. It would be helpful for the PS to include some examples demonstrating this.

Materiality judgements and stewardship

The revised objective of financial statements proposed in paragraph 3.4 of the IASB's recent Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* refers to providing information both for assessing the prospects for future net cash inflows to the entity and for assessing management's stewardship of the entity's resources. While stewardship is mentioned in the PS, the guidance focuses primarily on judging whether information is material for assessing the prospects of future net cash inflows and most of the examples are described in this context. In our view, the guidance and examples should also consider how the need to assess management's stewardship impacts materiality judgements. It would be helpful for the PS also to consider the interaction between these dual objectives for financial statements.

Intentional misstatements

Paragraph 41 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is confusing, so we welcome the IASB's intention to clarify it in paragraphs 77 to 79 of the PS. However, short of amending IAS 8 itself—which we would recommend—the PS should be re-drafted because it reinforces the contradiction which is arguably inherent in the Standard.

An immaterial error, whether intentional or not, cannot lead to a 'presentation or result [that] could reasonably be expected to influence the decisions of the primary users of the financial statements', because, as paragraph 78 of the PS states, this would make it material. Clearly an error cannot be both material and immaterial.

In practice, it is difficult to distinguish between the deliberate immaterial misstatement (such as the application of the practical expedient in paragraph 64 of the PS) and the deliberate achievement of a particular result or presentation; in making the misstatement the preparer will know what the impact on results and presentation will be. What matters, as paragraph 78

implies, is whether the impact on results or presentation is material as this makes the misstatement material.

We would welcome a clarification in the PS that misstatements are not automatically considered to be material simply because they are deliberate. However, an error which in isolation may be considered immaterial, is material if the resulting presentation could reasonably be expected to influence the decisions of the primary users.

To make this distinction clear, paragraph 79 should distinguish not only between 'management deciding not to discount a liability' and 'deliberately choosing an inappropriate discount rate in order to reduce the amount of the liability', but also to management deciding (legitimately) not to update the discount rate applied to a liability due to the impact being immaterial.

In the absence of this, the final sentence of paragraph 79 seems to imply that when a company decides not apply the appropriate discount rate to a liability because it has determined that the difference in the measurement of the liability that would result from updating the discount rate would not be material, this is nevertheless deemed to be a material misstatement due to a presumption that the purpose of any intentional misstatement is to 'achieve a particular presentation of an entity's financial position, financial performance or future cash-flows'.

Significant assumptions, estimates and uncertainties

Paragraphs 122 and 125 of IAS 1 require the disclosure of significant assumptions, estimates and uncertainties. The accounting for some items may require the use of best estimates (for example, when determining fair values) and may involve the use of practical expedients. Disclosure of uncertainties and contingencies may involve estimates of amounts and the likelihood of occurrence. Practical examples of how to apply materiality to these disclosures would be very useful.

Interim financial reporting

The application of materiality to interim financial statements is challenging, particularly given the greater reliance on estimates as acknowledged in paragraph 23 of IAS 34 *Interim Financial Reporting* (IAS 34). As currently drafted, the PS primarily reiterates paragraphs of IAS 34. In our view, it would be helpful for the PS to illustrate how materiality should be applied to interim financial data given that the interim financial statements serve a different purpose to the annual financial statements. The PS highlights that 'interim financial statements focus on new activities, events and circumstances and do not duplicate information previously reported' and some examples of how this principle affects the application of materiality would be useful.

Terminology

The PS does not distinguish between the various terms used to refer to materiality (for example: 'key', 'principal' and 'significant'). We believe that the PS provides an opportunity for the IASB to clarify the meaning of these terms and to consider revising IFRS literature to ensure that they are used consistently, making any hierarchical relationship between them clear.

Conflict with legal requirements

We do not envisage that the guidance will cause conflicts with legal requirements in the UK. The PS is consistent with the existing UK reporting framework and company law and, in any case, is non-mandatory.

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?

Yes, we agree that the IASB should not delay issuing the PS until the PoD project has been completed. However, should the PS require re-exposure, we believe that the IASB should ensure that the issuing of the PoD Discussion Paper is given priority in the allocation of resources so it is not delayed any further.

In our view the IASB should ensure that the definitions of materiality in the *Conceptual Framework for Financial Reporting* and the Standards are aligned. If such amendments are made after the PS is issued we suggest that the IASB updates the PS to ensure it is consistent with other IFRS literature, if required.

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.

No, we do not have any further comments.