

**IFRS Practice Statement: Application of Materiality to Financial Statements**

# **Feedback to constituents – EFRAG Final Comment Letter**

**March 2016**

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## Introduction

### Objective of this feedback statement

EFRAG published its final comment letter on the Exposure Draft ED/2015/8 IFRS Practice Statement *Application of Materiality to Financial Statements* (the ‘draft Practice Statement’) on 8 March 2016. This feedback statement summarises the main comments received by EFRAG on its draft comment letter and explains how those comments were considered by EFRAG during its discussions leading to the publication of EFRAG’s final comment letter.

### Background to the draft Practice Statement

The objective of the draft Practice Statement is to assist management in applying the concept of materiality to general purpose financial statements prepared in accordance with IFRS.

The draft Practice Statement discusses the characteristics of materiality, and provides guidance on judgements about materiality when deciding how to present and disclose information in the financial statements. In particular, the guidance covers:

- the objectives of the financial statements and how they relate to materiality decisions;
- when to aggregate and disaggregate information;
- making judgements about materiality in the context of the face of the financial statements; the notes and the complete set of financial statements; and
- how to deal with immaterial information.

Further details are available on the EFRAG [website](#).

### **EFRAG's draft comment letter**

EFRAG published a [draft comment letter](#) on the proposals on 27 November 2015. In the draft comment letter, EFRAG welcomed the issue of application guidance on materiality in the non-mandatory form of a practice statement. EFRAG considered that such guidance could be helpful, in particular in the context of disclosures, in order to provide a common ground for applying judgement in deciding which information is relevant for users and fostering thinking on how materiality is applied.

However, EFRAG considered that the objectives of the guidance should refer to all those involved in the issue of financial statements.

Furthermore, EFRAG considered that the guidance should be drafted in a more concise and practical way and focus on areas where it is most difficult to exercise judgement on the application of materiality.

### **Comments received from constituents**

EFRAG received fourteen comment letters from constituents that were considered by EFRAG in its discussions. The constituents are listed in the appendix and the comment letters are available on the EFRAG [website](#).

The comment letters received came from national standard setters, business organisations, a professional organisation and an EU authority.

All respondents considered that issuing guidance on materiality was helpful and that such guidance should be in a non-mandatory form. A majority of respondents also supported the proposed form of a Practice Statement.

A majority of respondents agreed with EFRAG that the Practice Statement should be drafted in a more concise and practical way and focus on the key steps of the process necessary to make decisions and exercise judgement on materiality.

Most respondents agreed that examples could be helpful and should focus on those areas where judgement is the most difficult to exercise.

Lastly, a majority of respondents supported the IASB's decision to issue the draft Practice Statement without waiting for the finalisation of its *Principles of Disclosure* project.

### **EFRAG's final comment letter**

EFRAG issued its final comment letter on 8 March 2016.

Considering the broad support for the views expressed in its draft comment letter, EFRAG retained, in its final comment letter, its support for the issue of non-mandatory application guidance on materiality in the form of a Practice Statement.

EFRAG also maintained its recommendations that:

- the objectives of the guidance be clarified to state that the practice statement can be useful, beyond preparers, to promote a common understanding of the role and application of materiality by all those involved in the issue of financial statements;
- the guidance be drafted in a more concise and practical way and focus on areas where it is most difficult to exercise judgement on the application of materiality; and
- the guidance is issued without waiting for the outcome of the Principle of Disclosure project.

EFRAG also considered, in its final comment letter, a number of drafting improvements suggested by respondents.

## Detailed analysis of issues, comments received and changes made to EFRAG’s final comment letter

### EFRAG’s tentative views expressed in the draft comment letter and constituents’ comments

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#### Objective and form of the guidance

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##### *Proposals in the ED*

The objective of the Practice Statement is to provide guidance to assist management in applying the concept of materiality to general purpose financial statements prepared in accordance IFRS.

The IASB proposes to provide guidance on the application of materiality in the form of a non-mandatory Practice Statement, rather than as mandatory guidance in a Standard. The IASB noted that if it issued mandatory guidance in a Standard, concerns about creating conflicts with national legal frameworks could add complexity.

##### *EFRAG’s tentative position*

EFRAG welcomed the issue of application guidance on materiality. EFRAG considered that such guidance could be helpful, in particular in the context of disclosures, in order to provide a common ground for applying judgement in deciding which information is relevant for users and fostering thinking on how materiality is applied.

However, EFRAG recommended the objectives of the guidance to refer to all those involved in the issue of financial statements.

Regarding the form of the guidance, EFRAG supported the proposed form of a practice statement.

### EFRAG’s response to constituents’ comments

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##### *EFRAG’s final position*

After considering the feedback received, EFRAG retained its tentative views expressed in its draft comment letter:

- supporting the provision of application guidance on materiality in the non-mandatory form of a practice statement; and
- recommending to clarify that the guidance is addressed to all interested parties, beyond preparers, to promote a common understanding of the role and application of materiality by all those involved in the issue of financial statements.

EFRAG noted the preference of two respondents for non-mandatory guidance to be attached to IAS 1. However, EFRAG observes that this standard relates to presentation and disclosures only, whilst the application of materiality also applies to recognition and measurement. EFRAG therefore believes that the issuance of the non-mandatory guidance as a standalone document is preferable.

**EFRAG’s tentative views expressed in the draft comment letter and constituents’ comments**

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**EFRAG’s response to constituents’ comments**

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*Constituents’ comments*

All respondents supported the issuance of non-mandatory guidance on the application of materiality. A majority of respondents also supported the issuance of that guidance in the form of a practice statement. However, two respondents considered that the guidance on applying the concept of materiality should rather take the form of Implementation Guidance or illustrative examples to IAS 1 Presentation of Financial Statements; and one respondent believed that it would be more suitable for its purpose and proposed content to be published as educational material.

One respondent observed that there will be strong pressure on entities to follow the proposed examples and practices. This aspect should also be taken into account in the drafting by focusing on the principles involved and how judgement should be applied, and the examples used should be illustrative but not be presented as the only possible approach.

Two respondents assessed that, if made mandatory, they did not foresee conflicts with legal requirements in their jurisdiction. Conversely, one respondent noted that the meaning of materiality for the purpose of ongoing market disclosure obligations could be different than for financial reporting, which may result in a conflict with local regulations. Other respondents did not comment on the issue.

Seven respondents also concurred with EFRAG’s view that the objective should also include other stakeholders involved in the issue or use of financial statements. Other respondents did not comment on the issue.

**EFRAG’s tentative views expressed in the draft comment letter and constituents’ comments**

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**Use of illustrative examples**

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*Proposals in the ED*

The draft Practice Statement includes a number of illustrative examples.

*EFRAG’s tentative position*

EFRAG agreed that examples could be useful to illustrate the way judgement on materiality is exercised. However, after having considered the examples currently included in the draft Practice Statement, EFRAG recommended that they should be improved so as to focus on those areas where judgement is assessed to be the most difficult to exercise and illustrate both decisions to include or to omit information from the financial statements.

*Constituents’ comments*

A large majority of respondents agreed that examples could be useful to illustrate the way judgement on materiality is exercised. A majority of respondents questioned the usefulness of some of the proposed examples in the draft Practice Statement as they were either self-evident or not explanatory enough about the factors that were considered in the thought process and how conclusion was reached.

One respondent disagreed with the proposed example where an item is judged to be material in the current period because it is expected to be material in the future, as this would stretch the concept of materiality unduly.

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**EFRAG’s response to constituents’ comments**

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*EFRAG’s final position*

After considering the feedback received from respondents, EFRAG maintained its tentative view that illustrative examples could be useful and recommending that the examples illustrate both decisions to include and to omit information and focus on those areas where judgement is most needed.

In its final comment letter, EFRAG also reflected some drafting improvements made from respondents.

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**EFRAG’s tentative views expressed in the draft comment letter and constituents’ comments**

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**Content of the draft Practice Statement**

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*Proposals in the ED*

The draft Practice Statement aims to propose 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 assessing materiality when applying recognition and measurement requirements.

*EFRAG’s tentative position*

EFRAG considered that the Practice Statement should be drafted in a more concise and practical way. EFRAG enumerated a number of such areas. EFRAG also suggested that the guidance would be more useful if it was structured along the key steps of the process inherent to decisions on materiality starting with the identification of information needed by users for their decision making. EFRAG has identified four major steps and suggested that they could be a basis for structuring the guidance.

*Constituents’ comments*

A majority of respondents agreed with EFRAG’s views and recommendations on the content of the Draft Practice Statement.

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**EFRAG’s response to constituents’ comments**

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*EFRAG’s final position*

EFRAG considered the feedback received that largely supported the views expressed in the draft comment letter and maintained its preliminary views. EFRAG also reiterated its suggestion that the structure of the Practice Statement could follow the key steps of the process necessary to make decisions and exercise judgement on materiality.

To address the concerns expressed by some respondents, EFRAG has included a recommendation to the IASB to align the guidance in the draft Practice Statement with the guidance in IAS 8 and consider whether the guidance contained in IAS 8 should be clarified.

In relation to the request to clarify the meaning of terms that are used to refer to materiality, EFRAG observed that a Practice Statement on the application of materiality is not the appropriate place to clarify the definition of such pervasive terms that are applicable across IFRS. However, EFRAG recommended that the IASB better illustrate how these concepts should be applied in practice.

EFRAG also considered drafting improvements made by some respondents in its final comment letter.

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**EFRAG’s tentative views expressed in the draft comment letter and constituents’ comments**

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One respondent, while supporting EFRAG’s recommendations, suggested to include an additional and final ‘step’ to the description of the thought process inherent to decisions on materiality that is to 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.

Several respondents expressed concerns on the guidance on ‘omissions and misstatements’ contained in paragraph 67-79:

- One respondent considered that references to internal control and governance, fraud and intentional misstatements should be removed;
- One respondent considered it was not convinced that the section has its place in a practice statement dealing with materiality;
- One respondent suggested to exclude practical expedients from the scope of the draft Practice Statement; and
- Two respondents considered that the guidance should be clarified and illustrate when intentional and unintentional misstatements are material to the financial statements.

Three respondents recommended that the IASB take advantage of the Practice Statement to try and clarify some of the terms that are used when referring to materiality (such as key, principal and significant).

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**EFRAG’s response to constituents’ comments**

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**EFRAG’s tentative views expressed in the draft comment letter and constituents’ comments**

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**Timing**

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*Proposals in the ED*

The IASB plans to issue the draft Practice Statement without waiting for the finalisation of its *Principles of Disclosure* project.

*EFRAG’s tentative position*

EFRAG supported the IASB’s decision as the application guidance contained in the draft Practice Statement provides useful guidance already in the context of the existing disclosure requirements.

However, EFRAG recommended that the IASB closely monitor the outcome of the *Principles of Disclosure* and other ongoing projects (such as the Conceptual Framework) to ensure that the Practice Statement is updated on a timely basis, if needed.

*Constituents’ comments*

A majority of respondents agreed with EFRAG’s tentative position. However, two respondents stated that some of the IASB’s proposals in the upcoming Discussion Paper on *Principles of Disclosure* could significantly impact the proposed guidance in the Practice Statement and therefore the respondents believed that the IASB should wait for the initial feedback by constituents on that discussion before finalising the guidance.

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**EFRAG’s response to constituents’ comments**

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*EFRAG’s final position*

After considering the feedback received, EFRAG maintained its support for the IASB’s decision and reiterated its recommendation that the IASB closely monitors the outcome of the Principles of Disclosure project and updates the Practice Statement as necessary.

However, EFRAG highlighted that its support for early publication is subject to the understanding that the discussion paper on Principles of Disclosure Project will not have a substantial effect on the proposed guidance.

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## APPENDIX: List of respondents

**Table: List of respondents**

<b>Name of constituent<sup>1</sup></b>	<b>Country</b>	<b>Type / Category</b>
Norwegian Accounting Standards Board	Norway	Standard Setter
Financial Reporting Council	United Kingdom	Standard Setter
Autorité des Normes Comptables	France	Standard Setter
European Banking Federation	Europe	Business Organisation
Danish Accounting Standards Committee	Denmark	Standard Setter
Instituto de Contabilidad y Auditoría de Cuentas	Spain	Standard Setter
Institute of Chartered Accountants in England and Wales	United Kingdom	Professional Organisation
Accounting Standards Committee of Germany	Germany	Standard Setter
Dutch Accounting Standards Board	Netherlands	Standard Setter
ACTEO AFEP MEDEF	France	Business Organisation
European Securities and Markets Authority	Europe	European Regulator
Federation of European Accountants	Europe	Professional Organisation
Insurance Europe	Europe	Business Organisation
Swedish Financial Reporting Board	Sweden	Standard Setter

<sup>1</sup> Respondents whose comment letters were considered by the EFRAG Board before finalisation of the comment letter.