

Association of Accounting Technicians response to the IASB Exposure Draft on “Application of Materiality to Financial Statements”

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1. Introduction

- 1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the IASB Exposure Draft on “Application of Materiality to Financial Statements” (the ED)¹.
- 1.2. AAT is submitting this response on behalf of its membership and for wider public benefit.
- 1.3. In responding to the questions set out in the ED AAT has focussed on the operational elements of the proposals and the related practicalities associated with implementing the measures outlined within the ED.
- 1.4. AAT has added comment in order to add value or highlight aspects that need to be considered further.
- 1.5. Furthermore, AAT’s comments reflect the potential impact that the proposed guidance would have on SME’s and micro-entities, many of which employ AAT members or would be represented by our operationally skilled licensed and regulated members in practice.

2. Executive summary

- 2.1. AAT considers that the Practice Statement will be welcomed by preparers and auditors of financial statements, as well as users of such, in providing guidance on applying the concepts of materiality.
- 2.2. Effective and efficient financial reporting depends on the ability of preparers to ignore immaterial errors or misstatements which could arise but would have no impact on users. However, the concept of materiality varies with different classes of users and in particular it is this aspect of users’ needs which preparers of financial statements need to recognise (3.5, below).
- 2.3. AAT has suggested an approach to the final procedures in preparing financial statements to ensure a proper consideration of the impact of materiality (3.5, below).
- 2.4. AAT considers that the notes to financial statements should contain sufficient information as regards matters based on subjective evaluations which could be materially misstated (3.8, below) and that preparers should take a prudent approach to such evaluations (3.10, below).
- 2.5. It is proposed by AAT that auditors should be required to formally report on materially subjective evaluations (4.1, below).
- 2.6. Similarly, audit exempt small entities should require input from independently regulated accountancy firms to provide users with the same level of confidence as for audited entities (4.2, below) and AAT’s Licensed Members are suitably qualified to provide this assurance.

¹ Published in October 2015

3. AAT response to the IASB Exposure Draft on “Application of Materiality to Financial Statements”

3.1. AAT’s responses to the questions raised in the ED are as follows:

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?

3.2. AAT supports the view that it is not practical to issue mandatory guidance due to the need to evaluate materiality in any situation, necessitating the employment of a subjective view of a number of interacting factors which realistically cannot be codified to provide for all possible situations.

3.3. AAT considers that a Practice Statement is a helpful tool to assist those responsible for financial statements to focus on matters which are of significant relevance to users.

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 specific as possible and explain why those example(s) would be helpful to entities.

3.4. As observed in 3.2 (above) it is difficult for guidance to provide a clearly defined authority to cover all possible situations, therefore examples are helpful to illustrate the thought processes to be applied in considering materiality, particularly in assisting with the consideration of marginal situations.

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 omission 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?**
- 3.5. AAT does not consider that any additional comment is required in the Practice Statement other than to suggest that while it is considered unnecessary to extend the examples given for each aspect of materiality concepts covered by the Practice Statement, it is important to focus on the approach taken by preparers when considering materiality.
- 3.6. Consequently, it would be helpful to provide a conclusion in the Practice Statement which stresses the definition of materiality, its subjective nature and the varied concepts of materiality appropriate to different classes of users of financial statements, together with possibly, an example of a “top down” approach to considering both the quantitative and qualitative elements of materiality which may impact on the users immediately before publication of the financial statements.
- 3.7. The example could take the form of a questionnaire or flow chart to encourage preparers of financial statements to carry out a materiality review as the last exercise in completing the financial statements, taking them through the following processes:
- 3.7.1. identify the different classes of users and their needs
- 3.7.2. identify those elements of the financial statements which would be sensitive to users separated between qualitative and quantitative aspects
- 3.7.3. for quantitative aspects, identify actual misstatements and those with the potential to contain material misstatements.
- 3.7.4. the actual misstatements which are material need to be corrected, as well as the immaterial misstatements (unless it results in undue costs or delays) and potential material misstatements need to be identifiable to users from information included in the financial statements
- 3.7.5. for material qualitative aspects of the financial statements, ensure adequate information is provided by way of notes to the financial statements
- 3.7.6. review the financial statements for irrelevant immaterial detail which can be removed or considered with other details.
- 3.8. Where estimates or other subjective evaluations are used in the preparation of financial statements, even though using the best information available, they could still have the potential to be materially inaccurate and the preparer has to determine an appropriate amount from a range of possible amounts to include in the main body of the financial statements.
- 3.9. AAT recommends that where such are identified as potentially having a material effect on any users, the notes to the financial statements should provide details of the basis of the evaluation and the potential range of misstatement so that users are fully informed and can make their own evaluation of the degree of prudence reflected in the financial statements.

- 3.10. The guidance should also stress that in areas of doubt as regards either excessive detail or the reliance on information as potentially material, a prudent approach should be adopted by making adequate disclosures.
- 3.11. The guidance should be easy to understand for those experienced preparers of financial statements. It is imperative that preparers should have an attitude of mind which understands and appreciates the needs of users of financial statements as regards the impact of materiality on the contents of financial statements.
- 3.12. There are no paragraphs or sections which are not acceptable to AAT.
- 3.13. There are no paragraphs or sections considered unnecessary by AAT.
- 3.14. AAT does not believe that any aspects of the guidance will conflict with legal requirements related to materiality within the UK.

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?

- 3.15. AAT is happy to see the Practice Statement issued by IASB before the finalisation of its Principles of Disclosure project and, in particular, the outcome to discussions on the definition of materiality.
- 3.16. Indeed the contents of the Practice Statement should be helpful to those discussions and in reaching a definition which will undoubtedly need to be largely subjective.
- 3.17. The difficulty in setting a definition is that materiality is a concept rather than a matter of fact and is basically a misstatement which would significantly impact on a reader's understanding and interpretation of the financial results and position of the entity concerned, and so is wholly subjective.
- 3.18. AAT considers that the inevitably subjective nature of any definition of materiality leads to guidance being more important and useful than any attempt to comprehensively define the concept.
- 3.19. Given that the Practice Statement will be revisited once the Principles of Disclosure project has been completed, there can only be benefit in issuing the Practice Statement at the earliest opportunity.

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.

3.20. AAT does not have any other comments to make on the draft Practice Statement.

4. Other points worthy of note

- 4.1. While it may not be appropriate for inclusion in the Practice Statement, as it is intended to be a guidance document only, there are further consequences which AAT considers need to be addressed. The auditor's report should also contain an opinion on those potentially material elements of the financial statements which are based on subjectivity, uncertainty, judgement or bias contained in financial statements, which is of greater benefit to users than the statement that the financial statements represent "a true and fair view" and who can then understand the degree of any uncertainties as well as the margins of subjectivity inherent in the financial statements and form their own opinions as to the degree of prudence reflected in the financial statements.
- 4.2. Such an approach would leave small entities exempt from audit not providing the same level of confidence to users of their financial statements. Some small entities exempt from audit may be of a substantial size with relatively sophisticated management structures and the facility to prepare statutory financial statements in-house, possibly without any need for ethical considerations to be reflected in those financial statements. Users of statutory financial statements not subject to audit, particularly suppliers and lenders, need to have assurances as to the reliability of those financial statements, as well as understand the degree of any uncertainties and the margins of subjectivity inherent in the financial statements.
- 4.3. AAT believes that there is a significant issue as regards the credibility of financial statements which are exempt from audit. At present, exemption from audit is available to "small" entities which can be of a substantial size leaving users of their financial statements with uncertainties as to whether the financial statements reflect any material bias or imprudent subjectivity in their preparation, or whether they have been subjected to any independent scrutiny.
- 4.4. AAT considers that the confidence of users in financial statements of small entities could be enhanced by requiring a new approach to the method of preparing such. Entities which are currently exempt from audits on the basis of being below the size thresholds should be required to have their financial statements prepared by an independent firm of accountants with a recognised professional qualification and regulated by a professional body, such as AAT, which would confirm in an attached report, the basis of preparation and limitations as regards reliance on the reported results and financial position (similar to the additional information suggested for inclusion in auditors' reports on audited financial statements referred to in 4.1, above). In this way the independent firm will be responsible for making judgement as regards the application of prudence in particular and for providing users with sufficient information for users to understand the risks attaching to the financial statements.

5. Conclusion

- 5.1. AAT broadly supports and agrees with the guidance given in the Practice Statement on "Application of Materiality to Financial Statements" but has made suggestions for ensuring that the guidance stresses that identifying users' needs is paramount in determining what is a material matter in financial statements.

- 5.2. AAT considers that it would be helpful for the Practice Statement to direct the attention of preparers of financial statements to the materiality aspects of their financial statements as one of the final exercises before publication (3.6, above).
- 5.3. As referred to in detail in section 4 above, AAT believes that the needs of users of financial statements would benefit from greater information being provided by auditors in their formal reports, with changes in the procedures for the preparation of financial statements for audit exempt entities to provide users with greater confidence

6. About AAT

- 6.1. AAT is a professional accountancy body with over 49,700 full and fellow members² and 85,500 student and affiliate members worldwide. Of the full and fellow members, there are over 4,200 members in practice who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.
- 6.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

7. Further information

If you have any questions or would like to discuss any of the points in more detail then please contact AAT at:

email: consultation@aat.org.uk and aat@taxpolicyadvice.com

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² Figures correct as at 31 Dec 2015