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IFRS Notes

IASB provides guidance on making materiality judgements and proposes amendments to the definition of material

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Background

International Accounting Standard (IAS) 1, *Presentation of Financial Statements* and IAS 8, *Accounting Policies, Changes in Accounting Estimates* define the term 'material' as follows:

'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.'

The International Accounting Standards Board (IASB) observed that entities face difficulties in making material judgements while preparing their financial statements. These difficulties were not only behavioural in nature but also relate to the existing definition of the term material.

New development

Recently, the IASB issued the following two documents in relation to the definition of 'material' and guidance on making materiality judgements:

- IFRS practice statement on 'making materiality judgements' (practice statement).
- Amendments to IAS 1 and IAS 8 by issuing an Exposure Draft ED/2017/6 *Definition of Material* (ED).

This issue of IFRS Notes provides an overview of these publications.

Overview of the practice statement

The practice statement is non-mandatory in nature and does not change or introduce any new requirement in IFRS. It provides guidance on the process that entities may follow to make materiality judgements when preparing their financial statements. The following section provides an overview of the guidance in the practice statement:

- **Objective and scope:** The practice statement is aimed at providing reporting entities non-mandatory guidance on making materiality judgements, while preparing general purpose financial statements in accordance with International Financial Reporting Standards (IFRS).

  An entity applying the practice statement is not required to state compliance with the IFRS.

  Additionally, it is not intended for entities applying the IFRS for Small and Medium Enterprises (SMEs) standard.

- **Basis of materiality judgements:** The objective of the financial statements is to provide financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors (its primary users) in making decisions about providing resources to the entity. An entity identifies the information necessary to meet the objective by making appropriate materiality judgements.

  While making such judgement, the entity considers both its specific circumstances and how the information provided in the financial statements responds to the information needs of the primary users. Since, an entity's circumstances change over time, the practice statement requires reassessment of materiality judgements at each reporting date.

  Entities make materiality judgements not only when deciding what information to disclose and how to present it, but also when making decisions about recognition and measurement in the following manner:

  – *Recognition and measurement:* As per the practice statement, an entity is only required to apply recognition and measurement requirements when the effect of applying them is material.

  – *Presentation and disclosure:* An entity need not provide a disclosure specified by an IFRS standard if the information resulting from that disclosure is not material.

- **Materiality process:** In order to help preparers of the financial statements make materiality judgements, the practice statement provides a four-step process. These steps focus on the factors an entity should consider while making materiality judgements. The steps are as follows:

  a) **Step 1 - Identify**: This step requires identification of information that has the potential to be material considering requirements in IFRS and primary users' needs.

     An entity considers requirements of the IFRS standards applicable to its transactions, other events and conditions as a starting point for identifying this information.

Overview of the practice statement (cont.)

Additional consideration to be given to the primary users' common information needs to identify any information that is necessary to enable primary users of the financial statements to understand the impact of an entity's transactions, other events and conditions on the entity's financial position, financial performance and cash flows.

The output of this step is a set of *potentially material information*.

b) **Step 2 - Assess**: In this step, an entity assesses whether the potentially material information identified in step 1 is, in fact, material. Such an assessment could be made after considering relevant quantitative and qualitative factors. The assessment is made in the following manner:

- An information is *quantitatively* material if the size of the information about the transaction, other event or condition could **reasonably be expected** to influence an entity's primary users' decisions about providing resources to the entity.
- *Qualitative factors* are characteristics of an entity's transactions, other events or conditions, or of their context that, if present, make information **more likely** to influence the decisions of the primary users of the entity's financial statements. These factors could be further classified as entity-specific and external factors.

  For example, the involvement of a related party or a transaction with uncommon or non-standard features may be a relevant qualitative factor.

The practice statement indicates that the presence of qualitative factors lowers the thresholds for the quantitative assessment. The more significant the qualitative factors, the lower will be the quantitative threshold used to determine if an item of information is material.

The output of this step is a *preliminary set of material information*.

c) **Step 3 - Organise**: This step requires preparers of financial statements to organise the information in a way that communicates the information clearly and concisely to its primary users.

The output of this step is the *draft financial statements*.

d) **Step 4 - Review**: In this step, an entity is required to assess whether the information is material both individually and in combination with other information in the context of its financial statements as a whole. This review gives an entity the opportunity to 'step back' and consider the information provided from a wider perspective and in aggregate.

The output of this step is the *final financial statements*.

- **Others**: The practice statement also provides additional guidance with respect to some of the common areas of judgement. These are as follows:

– *Prior period information:* IFRS standards require an entity to present information in respect of the preceding period for all amounts reported in the current period financial statements. However, assessment of whether the prior period information is material to the current period financial statements would require an entity to:

a) Provide more prior period information than was provided in the prior period financial statements, or

b) Provide less prior period information than was provided in the prior period financial statements.

Additional consideration to be given to the requirements of the local laws and regulations which could demand inclusion of additional information to the minimum comparative information required by the standards. However, if an entity has to state compliance with IFRS standards, it cannot provide less information than required by the standards even if the local laws and regulations permit otherwise.

– *Errors:* Material errors are errors that individually or collectively could reasonably be expected to influence decisions that primary users make on the basis of those financial statements.

An entity should correct all material errors, as well as any immaterial errors made intentionally to achieve a particular presentation of its financial position financial performance or cash flows.

The practice statement points out that immaterial errors, if not made intentionally to achieve a particular presentation, do not need to be corrected to ensure compliance with IFRS standards. However, correcting all errors (including those that are not material) in the preparation of the financial statements lowers the risk that immaterial errors will accumulate over reporting periods and become material.

Overview of the practice statement (cont.)

Additionally, it requires that all cumulative errors[1] should also be corrected if they become material to the current period financial statements.

([1]Uncorrected errors that have accumulated over more than one period.)

– *Information about covenants:* An entity assesses the materiality of information about the existence and terms of a loan agreement clause (covenant), or of a covenant breach, to decide whether to provide information related to the covenant in the financial statements. This assessment could also be made by following the four step materiality process as per the practice statement.

Additionally, while making this assessment, an entity should consider:

a) The consequences of a breach occurring i.e. the impact a covenant breach would have on the entity's financial position, financial performance and cash flows and

b) The likelihood of a covenant breach occurring i.e. the more likely it is that a covenant breach would occur, the more likely it is that information about the existence and terms of the covenant would be material.

– *Materiality judgements for interim reporting:* An entity makes materiality judgements in preparing both annual financial statements and interim financial reports prepared in accordance with IAS 34, *Interim Financial Reporting*. While making materiality judgements on its interim financial report, an entity focus on the period covered by that report, i.e.:

a) It assesses whether information in the interim financial report is material in relation to the interim period financial data and not annual data

b) It applies the materiality factors on the basis of both the current interim period data and also, whenever there is more than one interim period (e.g. in the case of quarterly reporting), the data for the current financial year to date

c) It may consider whether to provide in the interim financial report information that is expected to be material to the annual financial statements.

The entity could apply the materiality process in making materiality judgements in preparing both annual financial statements and interim financial report as per the practice statement.

- **Applicability:** An entity that chooses to apply the guidance in the practice statement is permitted to apply it to financial statements prepared from 14 September 2017.

Overview of the ED proposing amendment in the definition of the term 'material'

The definition of material has been discussed by the IASB in various projects including the conceptual framework project, the principles of disclosure project and the practice statement. These projects include similar but not identical versions of the definition of material.

Therefore, in order to avoid confusion, the IASB proposed amendments to the definition of material in IAS 1 and IAS 8 separately through an ED.

Accordingly, the revised definition of material proposed to be included in IAS 1 and IAS 8 is as follows:

'Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of a specific reporting entity's general purpose financial statements make on the basis of those financial statements.'

The amendments to the definition have been proposed on the following basis:

- **Consistent with the definition proposed in the ED on Conceptual Framework:** The IASB has used language that is consistent with the definition of material as proposed in the ED on Conceptual Framework for Financial Reporting (issued in May 2015). The IASB found the definition proposed in the ED on conceptual framework clearer than the existing definition in IAS 1 and IAS 8.

- **Consistent with other provisions of IAS 1:** The proposed definition of material incorporates following existing requirements in IAS 1 to give them more prominence:

  – Paragraph 7 of IAS 1 states that 'the assessment needs to take into account how users with such attributes *could reasonably be expected* to be influenced in making economic decisions'. Therefore, based on the requirements of paragraph 7, the threshold 'could influence' has been replaced with 'could reasonably be expected to influence' in the definition.

Overview of the ED proposing amendment in the definition of the term 'material' (cont.)

– Paragraph 30A of IAS 1 states that 'an entity shall not reduce the understandability of its financial statements by *obscuring material information* with immaterial information'. Therefore, to align with the requirements of paragraph 30A, it has been proposed to include the term 'obscuring information' in the definition.

The ED highlights that if any change is made to the definition of material in IAS 1 and IAS 8 as a result of the proposals, similar amendments would be made to the materiality practice statement and the forthcoming revised conceptual framework.

Comments to the ED may be submitted up to 15 January 2018.

Our comments

The application of the concept of 'materiality' and making materiality judgements have always been important in the preparation of financial statements. However, managements are often uncertain about how this concept should be applied in practice and may use the disclosure requirements in IFRS as a checklist. With the issuance of the practice statement, IASB has addressed some of the practical challenges being faced by the entities in this aspect.

The practice statement emphasises that determining what information should be disclosed is a matter of judgement and not a compliance exercise. It incorporates various examples that are expected to help entities better relate to and apply the guidance in individual circumstances. Additionally, the materiality process introduced in the practice statement provides a systematic approach to making materiality judgements that could be followed by entities for presenting more effective and meaningful financial information.

The proposed change to the definition of materiality in IAS 1 and IAS 8 is also expected to enhance consistency across the IFRS framework and standards. However, the reference in the definition to obscuring material information could be challenging to implement in practice.

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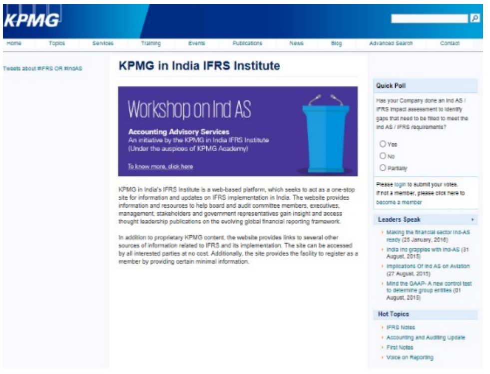
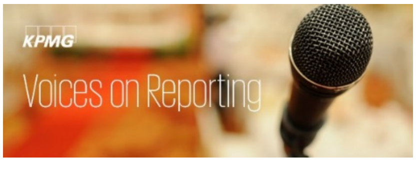
KPMG in India's IFRS institute



Visit KPMG in India's IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

Voices on Reporting

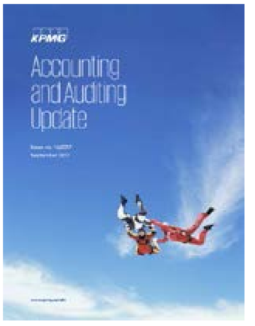


KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

In our recent Voices on Reporting webinar held on 4 October 2017, we covered key financial reporting and regulatory matters that are expected to be relevant for stakeholders for the quarter ended 30 September 2017.

The session included key updates from the Ministry of Corporate Affairs (MCA), the Institute of Chartered Accountants of India (ICAI) and the Securities and Exchange Board of India (SEBI).

Missed an issue of our Accounting and Auditing Update or First Notes



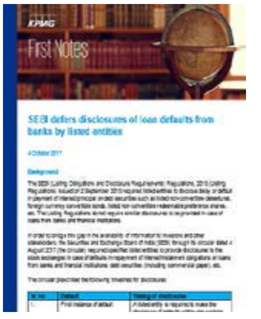
Issue no. 14/2017 – September 2017

In this edition of Accounting and Auditing Update (AAU), we highlight certain practical application areas associated with the accounting and presentation of NCI e.g. manner of attribution of profits and losses, impact of potential voting rights, sale/purchase of equity to/from NCI, etc.

The Companies Act, 2013 (2013 Act) article provides an overview of the 2013 Act's requirements with respect to depreciation and also integrates the guidance provided in the application guide and guidance note on accounting of depreciation issued by the Institute of Chartered Accountants of India (ICAI).

This publication also carries an article on goodwill impairment accounting under Ind AS. Additionally, certain disclosures relating to goodwill e.g. sensitivity analysis and estimate of recoverable amount are most challenging. Therefore, our article elaborates on the key considerations and disclosures that an entity should focus while conducting a goodwill impairment test.

Our publication also carries a regular synopsis of recent regulatory updates in India and internationally along with an article highlighting key clarifications provided by ICAI in its education material on Ind AS 16, *Property, Plant and Equipment.*



SEBI defers disclosures of loan defaults from banks by listed entities

4 October 2017

In order to bridge the gap in the availability of information to investors and other stakeholders, the Securities and Exchange Board of India (SEBI) through its circular dated 4 August 2017 (the circular) required specified listed entities to provide disclosures to the stock exchanges in case of defaults in repayment of interest/instalment obligations on loans from banks and financial institutions, debt securities (including commercial paper), etc.

While the above mentioned circular was to be effective from 1 October 2017, SEBI through a press release dated 29 September 2017 has decided to defer the implementation of the circular until further notice.

This issue of First Notes provide an overview of the SEBI press release issued on 1 October 2017.

Previous editions are available to download from: www.kpmg.com/in