



Kristy Robinson
Technical Principal
International Accounting Standards Board
30 Cannon Street
London
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3 June 2014

Dear Kristy,

Request for information on the application of materiality

Thank you for inviting the UK Financial Reporting Council (FRC) to provide input into the IASB's research project on materiality. The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC's responsibilities include setting accounting and auditing standards as well as enforcing those standards.

We welcome the IASB's disclosure initiative and we consider that it would be helpful for the IASB to:

- provide guidance on what materiality means from a disclosure perspective;
- include an explicit statement around disclosure of immaterial information in the Conceptual Framework; and
- reduce and defines the "magnitude" terms used in IFRSs, such as "significant", "key" and "critical".

We have set out in the attached memo, details on the concept and application of materiality in the UK including references to the relevant guidance in this area.

If you would like further information on any of the aspects outlined in the memo, please contact me.

Yours sincerely

A handwritten signature in black ink that reads 'DRaval'.

Deepa Raval
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Memo

Concepts and application of materiality in the UK

Introduction

The financial reporting framework in the UK, including company law and accounting standards, contains references to materiality. However, different terms are often used to refer to materiality.

Company law

Although the Companies Act 2006 (the 'Act') does not use the term 'material', the concept is implicit in many of its requirements. The Act uses terms such as 'to the extent necessary', 'key' and 'principal' to refer to the application of the concept of materiality to disclosures that are required by company law.

The FRC's *Guidance on the Strategic Report*¹ provides guidance on the application of materiality (section 5) to management commentary. In particular, the guidance explains that the application of materiality to the requirements in company law. The relevant extracts from that guidance are included below.

"...Where information is required 'to the extent necessary for an understanding', it should be included in the strategic report when it is material to shareholders (5.6).

"The terms 'key' (e.g. as used in the term 'key performance indicators' (KPIs)) and 'principal' (e.g. as used in the term 'principal risks and uncertainties') refer to facts or circumstances that are (or should be) considered material to a shareholder's understanding of the development, performance, position or future prospects of the business. For example, these could be the performance measures or risks considered by the board (5.7)".

Accounting standards

The concept of materiality is set out in the Accounting Standards Board's (ASB) *Statement of principles for financial reporting*² (SoP) and more recently in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*³. That standard is part of the suite of new UK Accounting Standards that will replace the existing UK Accounting Standards in 2015.

Statement of principles for financial reporting

The guidance on materiality is set out in paragraphs 3.28-3.31. The concept is described as follows:

"An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions

¹ The FRC Guidance on the Strategic Report will be available at <https://frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Ongoing-projects/Narrative-Reporting.aspx> from 5 June 2014.

² A copy of the ASB Statement of principles for financial reporting can be accessed at <https://frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Statement-of-principles.aspx>

³ FRS 102 can be accessed at <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-102-The-Financial-Reporting-Standard-applicabl.pdf>

of users of those financial statements, including their assessments of management's stewardship (3.30)."

The SoP also explicitly refers to immaterial information "when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded (3.29)."

FRS 102

"Information is material—and therefore has relevance—if its omission or misstatement, individually or collectively, could influence the economic decisions of users taken 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. However, it is inappropriate to make, or leave uncorrected, immaterial departures from this FRS to achieve a particular presentation of an entity's financial position, financial performance or cash flows (2.6)."

Auditing Standards

The UK and Ireland auditing standards are based closely on the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). ISA (UK&I) 320 (Materiality in planning and performing an audit) deals with applying the concept of materiality in planning and performing an audit of financial statements. ISA (UK&I) 450 explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. ISA (UK&I) 320 notes that financial reporting frameworks often include a discussion of materiality and, if so, that provides a frame of reference to the auditor in determining materiality for the audit. Otherwise, the characteristics referred to in paragraph 2 of ISA (UK&I) 320 provide such a frame of reference:

"... Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered."

Furthermore, under the ISAs (UK&I), the auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. The auditor is entitled to assume that users are reasonable in their knowledge of business and economics and in their economic judgments, are diligent in studying the financial statements and understand both the inherent uncertainties in financial statements and that the financial statements are prepared, presented and audited to levels of materiality.

ISA (UK&I) 320 requires the auditor to determine, for audit planning purposes, a materiality level (size) for the financial statements as a whole and, if applicable in the circumstances, lower levels of materiality for one or more particular classes of transactions, account balances or disclosures (paragraph 10). These levels do not establish the size below which a misstatement is always immaterial. Smaller

misstatements may be judged material in the particular circumstances (paragraph 6). In accordance with ISA (UK&I) 450 (paragraph A16), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements. Examples of such circumstances are given in that paragraph.

ISA (UK&I) 450 requires that the auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial (paragraph 5). Supporting application material (paragraph A2) explains that “clearly trivial” is not another expression for “not material.” Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with ISA (UK&I) 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

The current auditing standards focus on quantitative materiality. How to apply materiality considerations to non-quantitative disclosures is an issue that has been recognised. The IAASB has just issued an exposure draft⁴ of proposed changes to a number of ISAs regarding the audit of disclosures in financial statements. This includes proposed changes to ISA 320 to clarify that the nature of potential misstatements in non-quantitative disclosures is also relevant to the design of audit procedures to address the risks of material misstatement.

Insights into the consideration and application of materiality by auditors in the UK are given in the review paper ‘Audit Quality: Thematic Review of Materiality’⁵ which was published by the FRC in December 2013. This sets out the principal findings of thematic inspection reviews undertaken by the FRC’s Audit Quality Review (AQR) team during 2013.

Enforcement

The FRC’s Corporate Reporting Review team applies the concept of materiality in the same way as set out in accounting standards.

The FRC discourages companies from including unnecessary disclosures in their accounts. The Corporate Reporting Review Annual Report 2013⁶ notes that “few boards, however, appear to have followed the initiative shown by others last year who reviewed their accounts to highlight key messages and support them with relevant, concise disclosures such that they are not obscured by immaterial detail or repetition”.

Prudential regulation

It is our understanding that the application of the concept of materiality by the Bank of England’s Prudential Regulation Authority (PRA) is based on judgement, giving due consideration to both qualitative and quantitative factors, which take into account the nature, magnitude and impact of the matter under consideration. Broadly, there are no pre-set materiality threshold definitions for both disclosure and prudential requirements, with decisions and actions being driven by reasonable assessment of each case and the relevant PRA rules and guidance.

⁴ <http://www.ifac.org/sites/default/files/publications/files/IAASB-Disclosures-Exposure-Draft.pdf>

⁵ <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Materiality.pdf>

⁶ A copy of the 2013 annual report can be accessed at <https://frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Coporate-Reporting-Review-Annual-Report-2013.pdf>

References to further sources of guidance

FRC's thought leadership work

Cutting clutter⁷ – the FRC's 2011 discussion paper considers the behavioural influences that can be barriers to removing clutter. That paper notes the lack of clarity around what materiality means from a disclosure perspective (pages 20-23) and the difficulties associated with different terms being used in law, standards and other guidance to describe materiality.

Thinking about disclosures in a broader context⁸ – the FRC's 2012 discussion paper sets out a roadmap for a disclosure framework. One of the key elements of a disclosure framework is the consideration of materiality (pages 32-35). Appendix C of the discussion paper (page 52-55) sets includes thoughts for a framework for the application of materiality to the primary financial statements and notes.

The feedback statement⁹ for that discussion paper noted that “respondents mentioned materiality in the context of the undesirability of immaterial information being disclosed. It was mentioned that the ‘fear’ of materiality judgements being challenged resulted in the ‘checklist’ approach, which was seen as being the line of least resistance. More detail on the feedback relating to materiality is included in Materiality in pages 14-16 of the feedback statement.

Other references

January 2014 – FRC response to IASB's Discussion Paper 'A Review of the Conceptual Framework for Financial Reporting' (page 50).

<https://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRC-response-to-IASBs-A-Review-of-the-Conceptual.pdf>

March 2012 - Accounting Standards Board's response to ESMA Consultation 'Considerations of materiality in financial reporting'

[https://www.frc.org.uk/Our-Work/Publications/ASB/ASB-Response-to-ESMA-Consultation-Materiality-\(Mar\).pdf](https://www.frc.org.uk/Our-Work/Publications/ASB/ASB-Response-to-ESMA-Consultation-Materiality-(Mar).pdf)

June 2011 – Auditing Practices Board and Audit Inspection Unit's response to IAASB Discussion Paper 'The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications'.

<http://www.ifac.org/sites/default/files/publications/exposure-drafts/comments/5064-response-to-iaasb-re-disc.pdf>

June 2008 – Institute of Chartered Accountants in England and Wales Technical Release 'Guidance on Materiality in Financial Reporting by UK Entities'

<http://www.icaew.com/~media/Files/Technical/technical-releases/legal-and-regulatory/TECH-03-08-Guidance-on-Materiality-in-Financial-Reporting-by-UK-entities.pdf>

⁷ Cutting clutter is available at <https://www.frc.org.uk/getattachment/8eabd1e6-d892-4be5-b261-b30cece894cc/Cutting-Clutter-Combating-clutter-in-annual-reports.aspx>

⁸ Thinking about disclosures in a broader context is available at <https://www.frc.org.uk/getattachment/99bc28b2-c49c-4554-b129-9a6164ba78dd/Thinking-about-disclosures-in-a-broader-contex.aspx>

⁹ The feedback statement can be accessed at <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Thinking-about-disclosures-in-a-broader-contex/Feedback-Statement/Feedback-Statement-Thinking-about-disclosures-in-a.aspx>