Thinking allowed
Materiality

Judgements around financial report disclosure

Those responsible for preparing, or approving for release, a general purpose financial report need to make judgements about what information to include in the report and how to present it. In simple terms, what information is **material**?

If you have this responsibility, this Deloitte publication is designed to help you think about matters such as:

- how to identify who the primary users of your report are;
- how to identify what information those users want, or expect to be, included in the report;
- what factors should be considered in deciding whether information is material, including what qualitative factors can make small amounts material; and
- how to reduce the amount of immaterial information in your report, ensuring that material information is not obscured.

This makes this publication particularly relevant to directors, CEOs and CFOs.

Thinking allowed is a new series. It focuses on issues related to corporate reporting, whilst also providing insights and thought provoking commentary on a broad range of everyday matters that affect those preparing general purpose financial reports.

Contents

The challenge is in applying materiality principles to the explanations, financial and non-financial information in the supporting notes.

Introduction

There is a widely held perception that financial reports are less relevant than they could be. The International Accounting Standards Board (IASB) acknowledged these concerns when it established its *Disclosure Initiative.*

As part of its initiative the IASB identified ways of changing IFRSs to improve the quality of disclosures in financial statements. Much of its work is focused on the explanatory notes, which comprise by far the largest portion of a complete set of financial statements. It is here that concerns are often expressed about a lack of clarity, and the sheer volume, of disclosures – the notes are cluttered and important information is obscured by large volumes of "required disclosures".

Many reports, and the IASB, cite a lack of understanding of how to apply materiality to the explanatory notes as contributing to the problem.[1] We agree. We think that sensible application of materiality principles can lead to financial reports that are more fair, balanced and understandable – i.e. more useful.

Although we think that the general concept of materiality is well understood, much discussion of materiality focuses on errors and misstatements as they affect the primary financial statements. The challenge is in applying materiality principles to the explanations, financial and non-financial information in the supporting notes.

It is also encouraging that the International Auditing and Assurance Standards Board (IAASB) has been amending its International Standards on Auditing (ISAs) in relation to how auditors should consider classification, aggregation and disaggregation of information.[2] These recent changes should align more closely the questions preparers and auditors ask when they are reviewing financial statements disclosures.

This publication sets out the factors that we think are helpful in applying materiality to the explanatory notes, and to the financial report as a whole, and brings them together in a judgement framework.

1 EFRAG: *Towards a disclosure framework for the notes,* UK FRC: *Towards a disclosure framework for the notes; Thinking about disclosures in a broader context; Cutting clutter;* and ICAS/NZICA *Losing the excess baggage.*

2 See the revised International Standards on Auditing *Addressing Disclosures in the Audit of Financial Statements – Revised ISAs and Related Conforming Amendments.*

In plain language, applying materiality involves assessing the likelihood that including or excluding information, or changing how it is presented, will affect the decisions being made by the primary users of the report.

Materiality

The information presented by an entity in a financial report comes from the entity processing large numbers of transactions or other events and aggregating, summarising, classifying and presenting them in a report comprising the primary financial statements and their explanatory notes.

This process requires the preparers to decide what they think is the appropriate level of condensation and aggregation – or how to filter and summarise the information.

Materiality and financial reporting

The IASB has a definition of the term **material** in its Standards:

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.[3]

For those preparing financial reports in accordance with IFRS, this definition is an important foundation for making judgements about materiality.

However, this is not the only definition of materiality used in financial reporting. Other, similar, definitions have been developed within the legal frameworks of some jurisdictions. Although there are differences in wording, our assessment of the most common definitions of materiality is that they share a theme.

In plain language, applying materiality involves assessing the likelihood that including or excluding information, or changing how it is presented, will affect the decisions being made by the primary users of the report.

An entity preparing an IFRS financial report will need to be sensitive to how materiality is defined and applied in a particular jurisdiction. For example, an entity filing its IFRS financial statements in the U.S. will need to be aware of how the U.S. Supreme Court definition, and the guidance provided by the U.S. SEC., affect materiality judgements. Local enforcement and laws can help preparers identify information needs that are particularly important to the primary users in that jurisdiction.

3 IAS 1, paragraph 7.

4 The IAS 1 definition refers to an item being material if "it *could* …influence [an] economic decision …" whereas the U.S. Supreme Court decision refers to whether "… there is a *substantial likelihood* that the disclosure or omitted fact *would* have been viewed by a reasonable investor as having *significantly altered* the total *mix of information* …" (emphasis added). The IASB is currently considering whether to amend its definition to change "would influence decisions" to "could reasonably be expected to influence decisions". However, the IASB's consultations suggested that such a change would be unlikely to make a practical difference in decision-making, but would helpfully emphasise that materiality decisions require judgement.

A judgement framework

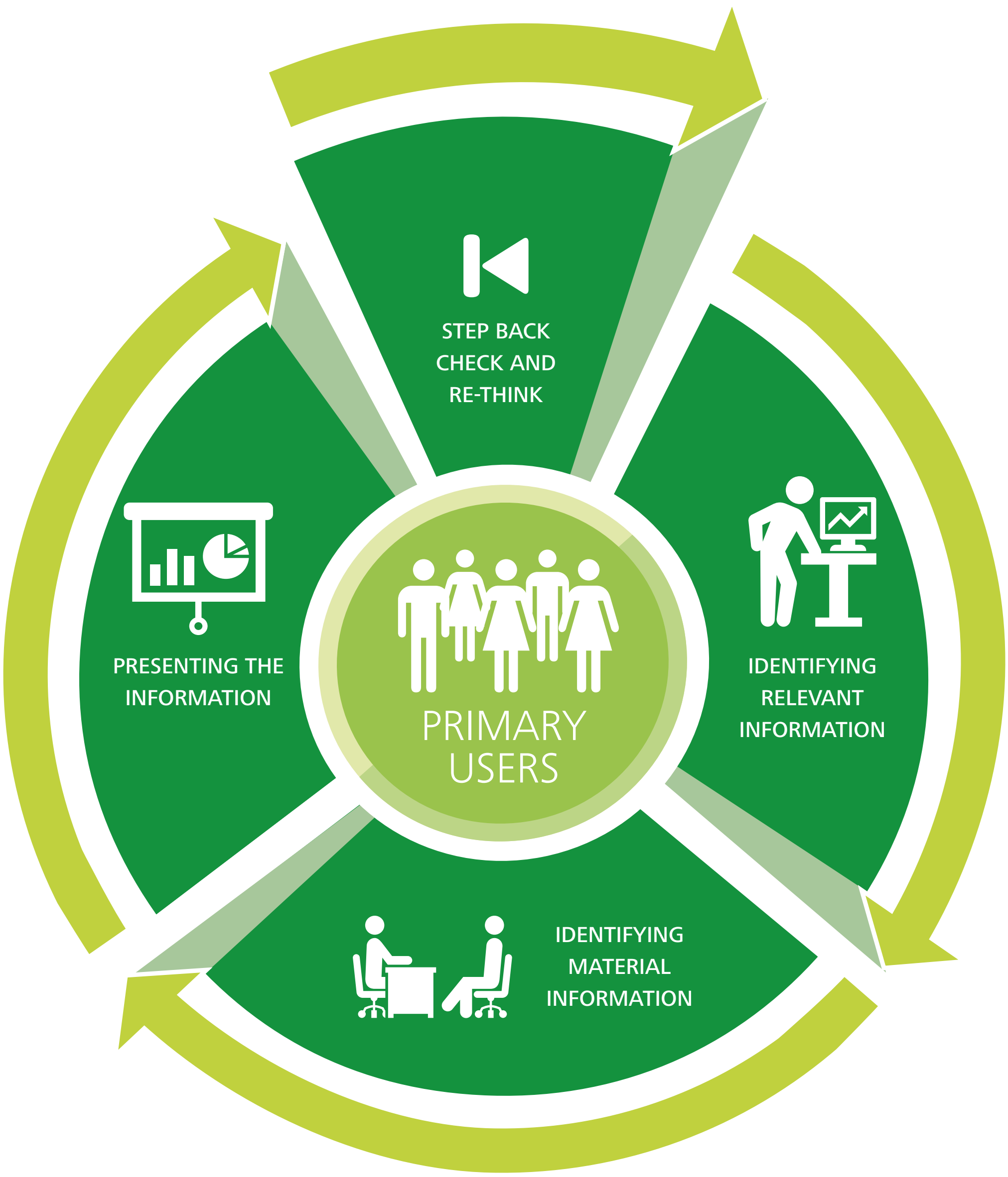
At the heart of the definition of materiality is a focus on the users of the financial report, and the need for preparers to decide what information will be important to **their** users.

This requires a good understanding of their characteristics and the types of decisions they are supporting with the financial report.

Meeting those needs requires you to assess what internal information should be included in the general purpose financial report – i.e. what to include, exclude and how to present it.

Those assessments require judgement. You will need to:

- Understand who your **primary users** are and the types of **decisions** they will use the financial report to help them make.
- Identify the information that is likely to be **relevant** to those users and, from this information set, work out what is **material** to them.
- **Present the information** in a meaningful way that emphasises those matters that are likely to be of most interest to the primary users.
- **Step back** and review the complete financial report.



The primary users

General purpose financial reports are intended to help a broad range of users, including investors, lenders, creditors, employees, regulators, tax authorities and members of the public.

Although general purpose financial reports are an important information source, they do not, and cannot, provide all of the information that primary users might use. You are entitled to assume that the primary users will consider information from other sources such as general economic, political and industry conditions and expectations.

It is essential that you know the main characteristics of your **primary** users, including whether your primary users include any groups with particular interests, and the types of decisions they are making. You should also know what type of information your primary users want, and expect, to be included in the report.

Identifying your primary users

At a minimum, the primary users of general purpose financial reports are existing and potential investors, lenders and other creditors of an entity.

These users are assumed to be well-informed, have a reasonable knowledge of business and economic activities and review and analyse the information diligently, although sometimes with the help of an adviser.[5]

Identifying what is important to them

Understanding what the primary user groups of a particular entity consider to be important is an essential element of applying materiality.

The mix of users might reflect some different preferences; meaning some information might be material to some primary users but not to others.

Investors, lenders and other creditors are likely to want information to help them make decisions related to providing resources to the entity. Those decisions include whether to buy, sell or hold equity and debt instruments, whether to provide or settle loans and other forms of credit, and voting as equity holders.[6]

Some shareholders could be more interested in corporate governance information than other shareholders. This could be because their main decisions relate to exercising their voting rights, rather than making buy, hold or sell decisions. Accordingly, some information such as director remuneration might be material to how they will vote on that matter but not material to an assessment of the value of the entity.

For example, some investment funds are required to hold a particular interest in companies in their investment portfolio, which makes the exercise of their voting rights more important than the buy, sell or hold decision.

Hence, a business could have different types of primary users with a range of different interests. You will need to use your judgement as to whether the mix of your current and potential investors and creditors means that you should provide more information to a particular type of primary user.

There are various ways to identify the types of decisions and information likely to be important to the primary users of an entity, including:

- Listening to what key stakeholders have said is important to them.
- Analyst reports.
- Questions from shareholder meetings and investor calls.
- Reviewing local, or relevant international, Corporate Governance codes.[7]
- Reviewing the information included in financial reports of others in the same industry, i.e. peer reviews.

It is also possible that you are focused on a particular type of investor. For example, you might be positioning the entity to appeal to “ethical” investor funds. Some of the information that will be of interest to that type of investor might not be as important or relevant to other investors or creditors.

---

5 Conceptual Framework, paragraph QC32.

6 See the objectives chapters of the IASB’s *Conceptual Framework for Financial Reporting* (Conceptual Framework).

7 See, for example, the *UK Stewardship Code* and the *Japanese Corporate Governance Code*.

Relevance and materiality are sometimes confused, or used interchangeably. IFRSs describe the information that is relevant to assessing particular matters.

Relevant information

Materiality judgements involve summarising and filtering the information from the full set available to you, down to the focused and digestible set that is the financial report.

Identifying the pool of information that should be considered for inclusion in a financial report comes from understanding what was important to you and your business this year, including matters that have affected the industry or jurisdiction in which you operate. That information needs to be paired with the related financial and regulatory reporting requirements.

The IFRSs provide an appropriate basis for identifying relevant information, because IFRS assumes that the application of the standards, with additional disclosure when necessary, leads to financial statements that achieve a true and fair view of the financial position and performance of the reporting entity.

Relevance and materiality are sometimes confused, or used interchangeably. IFRSs describe the information that is relevant to assessing particular matters.

For example, IAS 40 *Investment Property* sets out what information the IASB considers to be relevant to an assessment of investment properties. If an entity has an investment property, the internal information system will include information that is relevant to that property. However, if the amount invested is trivial relative to the reporting entity's other assets, the information is unlikely to be of interest to investors. The information is therefore relevant to the investment property, but not material to the primary users of the financial report.

The internal management information system will contain much more information than is required by IFRSs. Issues discussed by the Board during the period, and matters that were discussed by the audit committee are good sources for identifying what you think is important to the entity.

You also need to establish whether other disclosure requirements are required by regulation, which is particularly common in regulated sectors but can also apply to a broad base of entities. In some cases these will be absolute requirements that do not have a materiality overlay, and must therefore always be provided.

Material information

The objective is to ensure that the financial report *as a whole* provides a faithful and helpful summary of the performance and position of the business. The test is therefore whether to include or omit some information, in the light of the other information contained in the financial report. What is the likelihood of the primary users reassessing their decisions?

Omitting or obscuring information

It is unfortunate that the IASB definition focuses on omissions and misstatements, because this has been interpreted by some as implying that materiality is only about making sure that information is not *omitted*.

Materiality assessments should include making sure that financial statements do not contain immaterial information that obscures information that is important to the primary users.

The IASB has indicated that it is considering proposing some modifications to the definition as part of its Disclosure Initiative to make it clearer that materiality also involves making sure that information is not obscured by immaterial information. We welcome that step.

Materiality assessments require consideration of the type of information and the amounts involved. Some information will be of interest to your primary users even though the amounts involved are small. You will need to have a system in place to ensure that you identify information that is unusual or sensitive and might therefore need to be disclosed in the report. You also need to be aware of the trends affecting your business that could make smaller amounts more sensitive to your primary users.

Entity Specificity

Focusing on information that is specific to the business can help filter out boiler-plate, generic, disclosures which can also reduce clutter. For example, the accounting policy information presented in the financial statements should focus on how the policies are relevant to the business and how you have applied them. Ensuring that the policy information is focused on the business avoids generic descriptions of IFRS requirements and can help ensure that the more important policies are more visible, reduces clutter and reduces the length of the policy section(s).

Auditors will also be looking to ensure that the policies have been applied "to classes of transactions, account balances and disclosures in the financial statements in the particular circumstances of the entity's operations and its environment."[8]

IFRS requirements

Although IFRSs are an important source for identifying information that might need to be disclosed, it is not a requirement to disclose every item specified in an IFRS. If the information is not material it need not be disclosed. Although this has always been the case, the IASB amended IAS 1 in 2014 to remove any doubt. The amended Standard now states that an entity "need not provide a specific disclosure required by an IFRS if the information resulting from that disclosure is not material. This is the case even if the IFRS contains a list of specific requirements or describes them as minimum requirements."[9]

In its Financial Statements for the year to 31 December 2014, the IFRS Foundation did not provide a detailed reconciliation of its opening to closing property, plant and equipment, as set out in paragraph 73(e) of IAS 16. Instead, the report simply states that "there have been no significant movements during 2014 other than depreciation."

8 ISA 700 *Forming an Opinion and Reporting on Financial Statements*, paragraph A3a.

9 IAS 1, paragraph 31.

Many preparers tend to err on the side of caution and leave information in the financial statements because the consequences of omitting information are perceived as being greater than including it in the financial statements. The problem this creates is that information that is not material to the users of the financial statements can obscure the material information, undermining the usefulness of the financial report.

However, it is also not appropriate to assume that disclosing only items specified in an IFRS is sufficient. You need to step back and ensure that the information provides a faithful and balanced summary of a particular matter. Is information beyond the items specified by an IFRS necessary to give a more complete picture?

You should consider whether the objectives set out in an IFRS's disclosure requirements are met. For some older standards the disclosure objectives are either unclear or absent. However, even in those cases it is generally possible to develop a reasonable sense of what the standard is trying to achieve.

For example, simply disclosing the existence of a legal claim against the entity, which might not even have been recognised as a liability, without explaining the circumstances is unlikely to meet the requirements of IFRS.

Auditors will be taking a similar approach when assessing financial statements. ISA 700 gives the example of omitting information about the circumstances that have given rise to an impairment loss as being a case when disclosing only the amount of that loss is unlikely to be sufficient.

Qualitative and quantitative assessment

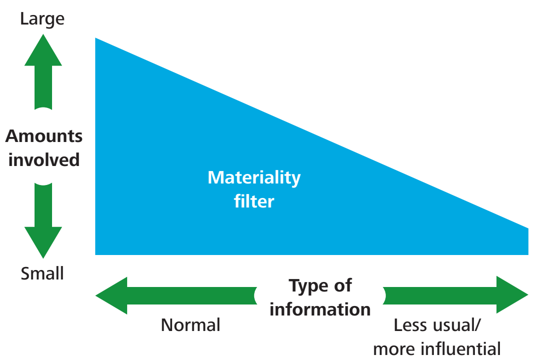
Materiality assessments require consideration of the **type** of information, and the **amounts** involved – qualitative and quantitative factors.

Qualitative characteristics relate to the quality or nature of the matter being assessed, rather than the amounts involved – such as for a receivable, the type, its terms, the type of counterparty, any security given by the counterparty, the currency it is designated in and so on.

Quantitative thresholds vary

The nature of the activity or item should inform you as to whether you should assign a higher or lower threshold in terms of the amounts involved. Information about individual run-of-the-mill activities is likely to be of less interest to the primary users.

It is for this reason that we sometimes see what look like high monetary materiality thresholds in large companies when it comes to assessing basic activities. On the other hand, the primary users are likely to be interested in knowing about remuneration of key personnel, one-off transactions and less usual matters, even if the amounts are smaller.



When it comes to assessing less usual items, IFRS already highlights some areas where the materiality threshold would be lower because of the nature of the information.

IAS 24 *Related Party Disclosure* can be thought of as a standard that provides guidance for applying materiality. Its objective is to "draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties."[10] Hence, for special relationships the threshold to warrant separate disclosure may be lower than for run-of-the-mill transactions.

IAS 1 gives examples of circumstances that could warrant the separate disclosure of items of income and expense, because they are "unusual". These include write-downs, or reversals of write-downs of inventories or of property, plant and equipment; the effect of restructurings; disposals of items of property, plant and equipment or investments; discontinued operations; litigation settlements; and reversals of provisions.[11]

There might also be some hot topics that increase the profile/materiality of particular issues, such as exposure to a particular sector or economy. The global financial crisis generated some such examples, and sometimes securities or banking regulators highlight such matters. In such cases disclosing the fact that, for example, an entity does not have any exposure to a particular sector or risk could itself be material – i.e. a nil balance can be material.

In some jurisdictions information is required to be disclosed by law. This might include investments in prohibited activities or jurisdictions, or for breaches of requirements.

10 IAS 24, paragraph 1.

11 IAS 1, paragraph 98.

To summarise

You should think about:

Relationships	Circumstances	Nature	Trends	Adequacy
Relationships – information about related parties, key management personnel, key suppliers or customers – could this be material to users?	The circumstances of the entity – e.g. a major business combination during the year.	The nature of the entity – e.g. banks would be expected to include more disclosure around risks.	Whether there are trends in the industry, market trends, hot topics that increase the profile/materiality of particular issues.	Whether more information is required to enable users to understand how judgements or estimates were made, or to understand a complex scenario.

Trends

Even materiality assessments for run-of-the-mill activities should not be made in isolation. There could be some slightly less than usual transactions, such as major sales or one-off expenses, which become important because they:

- have a disproportionate effect on a users' perception of ratios or metrics such as debt covenants, KPIs or remuneration metrics;
- turn a profit into a loss, such as if a profit target was only achieved by including the gain on a one-off sale;
- suggest that the entity has a broader problem with its systems, such as might be the case if it has a lot of small but systematic errors.

The effect on trends is acknowledged in IFRS 7 *Financial Instruments: Disclosures,* which requires an entity to disclose additional information if "the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period."[12]

Also, the item might not appear to be material now in terms of the amounts involved in the current period but it could be clear that it will affect the long term strategy of the entity or its ability to create value. This could be the case when an entity successfully patents a new product or receives poor results on a new product test such as a new drug. The primary users might have built an expectation of growth on the basis of earlier initial test results that they would modify in the light of the new information.

12 IFRS 7, paragraph 35. Similar requirements for other risks are contained in paragraphs 24D and 42 of IFRS 7.

How information is presented is part of the materiality assessment, because presentation can affect its usefulness, and how it is perceived by the primary users. In other words, presentation matters if it can influence or affect the decisions taken by the primary users.

Presentation and emphasis

How information is presented is part of the materiality assessment, because presentation can affect its usefulness, and how it is perceived by the primary users. In other words, presentation matters if it can influence or affect the decisions taken by the primary users.

It is not sufficient to argue that the information was included in the report if it is difficult to find. Nor is it appropriate if information that should be considered together, to provide a more complete picture of an aspect of the business, is presented as if it is not related. Providing more emphasis to some aspects of a transaction while deemphasising other aspects can undermine neutrality.

Part of the materiality decision therefore relates to identifying which matters should be given particular emphasis and which matters should be presented together, or at least related to each other by way of cross-reference.

Among the factors that you should consider are:

- Is the tone of the language used appropriate to the issue being conveyed? For example, a dismissive tone when discussing possible litigation against the entity when the litigant has reasonable grounds would not be appropriate.
- Are matters of particular importance given sufficient prominence?
- Is the information formatted in a way that communicates effectively? For example, data intensive disclosures such as maturity analysis or reconciliations are generally clearer when presented in a table.
- Are there any notes which have superfluous information that obscures the material information, such as generic statements that do not help the reader understand the particular circumstances of the entity?

Once a draft report has been prepared it is important to step back and review it.

Stepping back

Financial reports are often compiled from the bottom up, focusing on particular parts of the business or preparing notes related to individual items on the statement of financial position or the statement of comprehensive income. Assessing disclosure requirements on a standard-by-standard basis, or using disclosure checklists, can lead to a false sense that because the items are included in the report then the report is fair, balanced and understandable. Simply disclosing items specified in IFRS could lead to important information being omitted. And including all specified items could obscure material information.

Once a draft report has been prepared it is important to step back and review it. The report needs to present a cohesive summary of the financial performance and position of the business. It is through such a review that you can identify gaps in the information being presented or information that could be removed to make important information more accessible. How the information is presented is also important.

Matters you should consider are:

- Is there any information that could be removed, or summarised further, to reduce clutter or to make sure the information known to be important to the primary users is more accessible;
- Are there any gaps in the information that need to be remedied;
- Is the report structured in a way that gives appropriate emphasis to the matters they know were important to the entity during the period; and
- Is the tone and language balanced?

In other words, is the report fair, balanced and understandable?

The auditors will also be considering whether information has been appropriately classified, aggregated or disaggregated and characterised and whether they perceive there to be bias in the report. Recent changes to the Auditing Standards require that assessment to include consideration as to whether "the overall presentation of the financial statements has been undermined by including information that is not relevant or obscures a proper understanding of matters in the financial statements".[13]

13 ISA 700 *Forming an Opinion and Reporting on Financial Statements.*

Summary

There is no doubt that, on average, financial reports are not as concise or as useful as they could be. There are many reasons that financial reporting has reached this point – there is a lot of inertia in financial report preparation;[14] some information is repeated within a report rather than incorporated by cross-reference; regulatory and financial reporting requirements sometimes overlap; some financial reporting Standards use prescriptive and inflexible language; some preparers think that auditors and regulators are more likely to be appeased by including information than by filtering out immaterial information; the consequences of over-disclosing are perceived as being better than under-disclosing; and the concept of materiality can be difficult to apply to information that supports the primary financial statements.

It is this last point on which we have focused here, because applying materiality judgements effectively can help overcome many of these other factors.

The concept of materiality is used and applied widely within and outside of financial reporting. It is a term that is commonly used in contracts, across a range of contexts.

In plain language, something is material to a person if it influences the decisions they make. In the case of financial reporting the question is the influence a particular piece of information would have on a decision a person is making, when included in or omitted from a financial report.

There are two sides to this question – should the information that is known to you be included in the report; or is there information in the report that should be removed? Information should be added if it is likely to affect the decisions being made by the primary users. Information should be removed if it is not helpful to the users and detracts from information that is important to them.

Materiality involves judgement. Exercising that judgement requires that you understand:

- The characteristics of the primary users of the financial statements and the decisions they are using the financial report to support; and
- What information is relevant to particular types of activities of the business and the decisions being made by the primary users?

The key to making decisions about whether information is material is not to focus on the information in isolation. Rather, the question becomes one of whether the primary users to whom the financial report is directed are likely to want that information included in the report.

14 Preparers tend to add to last year's report rather than have a more open mind about whether something reported last year is material this year.

10 questions you should ask yourself

1. Do you know the main characteristics of your primary users?
2. Are there any issues that you think your primary users are particularly interested in having discussed in the current report, including matters that are of special interest to particular sectors amongst your primary users?
3. Are there any matters that you have considered this year, or are particularly sensitive within your industry, that should be addressed in the report?
4. Are there any disclosures that you are carrying forward from previous periods that no longer provide helpful information to your primary users?
5. Have you identified any items or information that should be disclosed separately, even though the amounts involved are not large, because they are unusual or sensitive?
6. Could a reader tell what you consider to be the main issues facing the business, and what has changed from the previous period, and is anything missing?
7. Do your accounting policies explain how you have applied the requirements in IFRS – i.e. have you minimised the generic descriptions about IFRS requirements?
8. Have you drawn together, into one section or by cross reference, matters that you think are related and should be considered together?
9. Is there any information in the report that could be summarised further, or even left out, that would make the information you know will be more important to your primary users more accessible?
10. Is the tone of the financial report as a whole balanced, using language appropriate for your primary users?

Contacts

If you would like to discuss any of the above matters with one of our experts, or simply for further information, please contact your local Deloitte partner or one of the following:

Veronica Poole
Global IFRS Leader
Direct: +44 20 7007 0884
Mob: +44 7711 954588
Email: vepoole@deloitte.co.uk

Alan Teixeira
Global Director, IFRS Research
Direct: +44 20 7303 3230
Email: alteixeira@deloitte.co.uk

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. J776