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Agenda Item

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Committee: IAASB

Meeting Location: Copenhagen

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Materiality

Staff Paper on Consideration of Definitions of Materiality in Financial Reporting Frameworks

Objectives of Agenda Item

At the April 2004 meeting of the IAASB there was support for a suggestion that if the applicable financial reporting framework provides a definition of materiality, the auditor should be required to use that definition when considering materiality for audit purposes. The revised ISA 320 would provide a definition for use when one is not given in the applicable financial reporting framework. To enable the IAASB to further consider this suggestion, it was requested that a paper be prepared considering the definitions of materiality that exist in different financial reporting frameworks.

This paper sets out the results of research into definitions of materiality in financial reporting frameworks¹. It starts by explaining some of the rationale behind the wording of the current revised definition proposed by the Task Force.

Current Definition in ISA 320

The existing definition of materiality in ISA 320 is taken from the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements":

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

As previously explained to the IAASB, the Task Force is concerned that this definition does not make clear the importance of considering the nature, as well as the size, of an item. It was primarily this concern that led to the development of a new definition by the Task Force. Other elements of the definition were then also considered.

¹ A request was sent to Technical Advisers of the IAASB members asking them to provide the definitions used in their local financial reporting frameworks.

Definition Proposed by the Task Force in April 2004

The draft definition developed by the Task Force, and included in the proposed revised ISA 320 presented at the April meeting of the IAASB, is:

“The auditor should consider a misstatement, or an aggregate of misstatements, to be material if, in the judgment of the auditor, it is probable that the effect of the misstatement, or aggregate misstatements, would reasonably change or influence economic decisions, taken on the basis of the audited financial statements as a whole, by users who have a reasonable understanding of business, economic activities and financial reporting. In deciding whether a misstatement or an aggregate of misstatements is material, the auditor should consider both the size and nature of the misstatement or aggregate misstatements judged in the particular circumstances of their occurrence.”

It is made clear elsewhere in the proposed revised ISA that “misstatements” include “omissions”.

In addition to the need to consider the nature as well as the size of items, the Task Force also thought it was important to indicate that:

- (a) The auditor considers whether misstatements probably change or influence economic decisions of users, rather than could influence economic decisions. Use of the term “could” potentially sets a very low bar.
- (b) The users of financial statements are “reasonable” when making decisions;
- (c) Users have a reasonable understanding of business, economic activities and financial reporting.

Definitions in Financial Reporting Frameworks

Details of the definitions of materiality in various financial reporting frameworks are set out below. Japan provides an example of a country where there is currently no definition of materiality, although the concept is recognized and discussed; Germany provides an example of a country where there is more than one definition, none of which is considered to be the most authoritative.

Generally, financial reporting frameworks recognize that preparers, and auditors, of financial statements are entitled to assume that users have a reasonable understanding of financial reporting etc., although this is not always clearly linked to discussion of materiality.

The frameworks also generally recognize that the nature of items is important as well as the size.

The following table sets out a summary of which definitions refer to “probable” or “could” with respect to effect on users’ decisions.

	Probable	Could
IAS		✓
Canada	✓	
Germany		✓
Netherlands		✓
UK	✓ (“reasonably expect”)	
US	✓	

INTERNATIONAL ACCOUNTING STANDARDS (IAS)

The revised International Accounting Standard 1 “Presentation of Financial Statements”, issued in December 2003, contains the following definition of materiality:

“Omissions or misstatements of items are material if they could, individually or collectively, 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.”

Guidance supporting this definition states:

“Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25 that “users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.” Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.”

A concern about this definition is the use of the term “could influence”, although this is mitigated to an extent by the expression “could reasonably be expected to be influenced” in the last sentence of the supporting guidance. In other respects it is not inconsistent with the definition developed by the Task Force.

In January 2004 there were nine liaison standard setter countries working with IASB towards global convergence of accounting standards:

- Australia
- Canada
- France
- Germany
- Ireland
- Japan
- New Zealand
- United Kingdom
- United States

Other countries involved in convergence are:

- China
- Hong Kong
- Singapore
- South Africa

South Africa has already harmonized its accounting standards with IASs. Australia is moving towards the adoption of IASs effective for accounting periods commencing on or after 1 January 2005. A European Community Regulation requires that consolidated accounts of publicly traded companies are prepared in compliance with International Accounting Standards with effect for accounting periods commencing on or after 1 January 2005. EC Member States can decide to what extent the requirement should apply to other types of entity: in the UK, for example, non listed companies will still be able to comply with UK accounting standards (although the UK Accounting Standards Board is moving over a number of years towards convergence with IASs).

Where countries will converge with, rather than adopt, IASs it remains to be seen to what extent they will adopt the IAS1 definition of materiality.

In light of the significant movement towards adoption/convergence with IASs, the staff propose that it would be helpful if the “default” definition of materiality provided in the revised ISA 320 were the same as the one given in revised IAS 1, with supporting guidance to explain, inter alia, that the auditor considers whether misstatements could reasonably be expected to influence the economic decisions of users.

CANADA

The Canadian Financial Statement Concepts define materiality as follows:

“Users are interested in information that may affect their decision making. Materiality is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.”

Of note in relation to this definition is use of the term “probable” and also that materiality is a matter of “professional judgment”.

For auditing purposes the same definition applies. Extensive guidance is provided on applying the concept of materiality in the conduct of an audit.

GERMANY

The applicable financial reporting framework in Germany does include definitions and descriptions of materiality, but there is no one authoritative definition. The definition of materiality from one of the more authoritative sources of Grundsätze ordnungsmäßiger Buchführung (GoB) literature (Ulrich Leffson, Die Grundsätze ordnungsmäßiger Buchführung, Sixth Edition, IDW-Verlag GmbH, Düsseldorf 1982, p. 166) is:

"For those preparing the financial statements, the principle signifies that in preparing the annual financial statements, all facts must be considered, that could influence the decisions of the recipients of the financial statements".

With respect to users, the same source states that "financial statement recipients" for the purposes of the determination of materiality are considered to be typical users with adequate technical knowledge and without particular preferences or risk profiles that rely solely upon the published annual financial statements for their decisions on the purchase and sale of securities. The concept of the "average prudent investor" is also mentioned.

German auditing standards are based in German law, and in particular, on the provisions of the German Commercial Code in relation to statutory audits. Article 317 Paragraph 1 Sentence 3 does specifically mention that audits are to be organized so that material misstatements are detected within the confines of professional due care, but the Code does not define materiality. However, the IDW Auditing Standard IDW PS 250 "Materiality in the Financial Statement Audit" does provide standards and guidance for auditors on the materiality issue. The definition of materiality for audit purposes (taken from a draft translation of the draft standard) is:

"The concept of materiality in an audit of financial statements says that an audit of annual financial statements and a management report, or consolidated financial statements and a group management report, is to be planned and performed such that misstatements which, because of their size or significance, have an effect on the informative value of the financial reporting for a user of the financial statements, will be detected with reasonable assurance. Considering materiality in an audit of financial statements enables the auditor to focus on matters significant to decision-making."

JAPAN

A definition of materiality is not directly dealt with in Japanese GAAP, whereas application of materiality concepts is provided. In this regard, "Supplement 1 Application of Materiality Concepts" in "Supplements to Accounting Standards for Business Enterprises" reads in a literally translated manner as follows:

"Although financial accounting for business enterprises should present an accurate computation in accordance with the prescribed accounting principles and procedures, it is permissible to apply other convenient methods to immaterial items without applying fundamental and rigid accounting principles and procedures. The objective of financial accounting for business enterprises lies in clarifying the financial condition and results of operations of a business enterprise and in presenting interested parties with the facts in such a way that will not be misleading in their interpretation of the financial status of a business enterprise. In this regard use of such convenient methods may be regarded as being in accordance with the principle of orderly accounting. ..."

In Japan, the Business Accounting Council (BAC) sets the "Auditing Standards", the basic framework of auditing standards, and the Japanese Institute of Certified Public Accountants (JICPA) sets the "Implementation Guidance", guidance for the application of the "Auditing Standards". Both the "Auditing Standards" and the "Implementation Guidance", together as one set, are deemed to be comparable to ISAs. The "Auditing Standards", which explains "Materiality in an Audit" in its preface, does not provide a definition of materiality. The "Implementation Guidance" does not directly deal with a definition of materiality either.

NETHERLANDS

Definition of materiality is the same as that in the IASB's "Framework for the Preparation and Presentation of Financial Statements" (and the extant ISA 320) – see above.

'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.'

The auditing standard is identical to ISA 320.

UNITED KINGDOM

The UK Accounting Standard's Board's "Statement of Principles for Financial Reporting" states:

"An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessment of management's stewardship.

Whether information is material will depend on the size and nature of the item in question judged in the particular circumstances of the case. ..."

The UK Auditing Practices Board's Glossary of Terms provides the following definition of materiality:

"An expression of the relative significance or importance of a particular matter in the context of financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditors' report. Materiality may also be considered in the context of any individual's primary statement within the financial statements or of individual items included in them. Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects."

UNITED STATES

Paragraph 132 of the FASB Concepts Statement No. 2 Discussion of Materiality includes the following statement about the essence of the materiality concept:

"The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

The extensive discussion of materiality in the preceding paragraphs of the Concepts Statement places significant emphasis on the need to consider the nature of an item and the circumstances as well as magnitude.

Guidance for auditor's in AU 312.10 refers to the above definition and also states that:

"The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations."

Action Requested

The IAASB is asked to review the above information and provide feedback to the Task Force on the following:

- (1) Should the proposed revised ISA be amended to require that auditors should use the definitions/discussion of the concept of materiality, where given, in the applicable financial reporting framework?
- (2) Does the IAASB agree with the staff proposition above that the "default" definition of materiality provided in the revised ISA 320 should be the same as the one given in revised IAS 1, with supporting guidance to explain that the auditor considers whether misstatements could reasonably be expected to influence the economic decisions of users?
- (3) Are there any other particular matters related to the definition of materiality that the Task Force should address in the proposed revised ISA 320?