MATERIALITY IN FINANCIAL REPORTING

An Integrative Perspective

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BY

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INVESTOR IN PEOPLE

To Anna, constant presence and support

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Preface

For financial statement neophytes, materiality looks like a philosophical issue, thought to be of little importance to practitioners and financial statements preparers adept to hard life. Yet, most of the internal management battles for what to filter through the internal reporting layers and what and how to disclose it in the external financial statements run on the verge of materiality.

Experienced financial statements preparers know that much of the discussion at the top management and board levels is on what to or not to present and disclose, justified on the grounds of materiality, but often for some other reason indeed. Auditors know that unless they can prove that a misstatement is material, their bullet would be smoothed. And if they did uncover something, they would pray that it was immaterial. Forensic analysts are aware that when a company says that something is not material, this alone is a good reason to investigate what this statement is trying to conceal.

Materiality is a slippery issue. Being so difficult and tricky, the FASB appears determined not to search for its definition in an accounting context. Standard-setters must serve a large audience, from preparers to investors. But preparers, indeed, are also among their stakeholders. They must find some trade-off: accounting is not for scientists and cannot be so difficult to be impossible or excessively costly. So, preparers push for materiality, invoking users, but really do users invoke materiality? Is this license too wide? It depends on how sophisticated the glasses of readers are, and from what angle they are viewing the scene. What could seem a departure from GAAP may in essence be acceptable as — somebody heard the auditor saying — it is not material. In a win-win situation, proving immateriality may give apparent relief to management for light sins and on the other hands be a useful defense to auditors. Investors, at least the most sophisticated of them, and financial analysts would rather have more information, because they know how to decide what is material to them. Securities regulators are obviously stricter than standard-setters.

Take it to the limit, somebody may have said after the fact, that it was too an immaterial issue to be of interest to users, and so this statement would be used to prove that before the fact there was an intent of fraud. The Court may have to say the last word.

This book offers an integrated perspective of materiality from the different angles of accounting standards for annual, interim, and segment reporting (including IFRS, US GAAP and SEC Rules and Regulations), auditing standards (including US and international ones), internal control over financial reporting, management commentary, financial analysis and management control, forensic analysis, sustainability reporting, corporate responsibility, assurance standards, integrated reporting, and limited legal considerations.

Part I introduces the background, including the scenario of the current debate as part of the IASB's Disclosure Initiative, the FASB's Disclosure Framework and the SEC's Disclosure Effectiveness Initiative.

Part II contrasts the views of the accounting conceptual frameworks. It then compares the definition of materiality in different standards and contexts, to then draw a taxonomy of materiality and its attributes.

Part III reviews the uses and effects of materiality as an accounting, legal, audit, and managerial concept. It counterbalances the interests and positions of the various stakeholders involved, such as investors, preparers, standard-setters, auditors, regulators, financial analysts, and other users of the financial statements. It then capitalizes on the author's vast experience in industry to devise alternative and complementary models of materiality with their pros and cons.

Part IV provides readers with interlinked guidance in accounting and audit about the extant requirements for the application of materiality to recognition, measurement, presentation and disclosure in the financial statements. It also expands to issues that are typical of management commentary. It informs about the complexities and subtle differences between financial statements and bookkeeping on the subject. Two full sections cover the application of materiality in auditing and in internal control over financial reporting, respectively.

Part V of the book goes into the details of how to assess materiality. It draws from a plethora of different disciplines to go to the essence of the very meaning and application of professional judgment and its multifaced aspects in specific scenarios and decisions. This section goes into practical guidance that rarely can be found on a such judgmental topic.

Part VI illustrates different approaches concerning the processes and methods that an entity can establish to determine materiality. Given the highly subjective nature of materiality assessments, proper processes, systems and methodologies are at the forefront of the recent and future developments in this area.

Part VII tackles specific issues of application of materiality. This section includes an illustration of SEC Staff comments on materiality in the review of Form 20-F of foreign private issuers and a checklist of specific accounting pronouncements relating to specific materiality decisions.

Part VIII of the book wraps up the whole content in showing how an experienced professional can handle discussions with management to uncover inappropriate schemes, manipulation tactics, if not frauds.

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Part I

Introduction and Background

Abstract

Part I introduces the background of why materiality matters in financial statements. One of the main reasons for determining whether a fact is material is to check whether its misstatement overtakes the watershed which makes financial statements not comply with the relative financial reporting framework.

This part also introduces one of the themes of the book: the interaction of the views of the different subjects involved in materiality assessment, i.e., users, preparers, auditors, regulators, and the related conflicts of interest. Materiality plays a different role in this depending on who is looking at it.

The part also comprises an overview of the main projects underlying the current debate about materiality, that is, the International Accounting Standards Board's Disclosure Initiative, the Financial Accounting Standards Board's Disclosure Framework and the SEC's Disclosure Effectiveness Initiative, including a list of their main steps and documents issued to date.

Keywords: Accounting; Compliance; Disclosure; Effectiveness; IASB; IFRS; Impracticability; Initiative; Maturity; Override; SEC; Undue; US GAAP

Main Focus of Part I

1. Why Does Materiality Matter in Financial Statements?

First and foremost, materiality in financial reporting is the focus of the lens of financial statement users in making their economic decisions. The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) conceptual frameworks contemplate this as the main argument, as discussed in Paragraph II.1 below.

However, in practice, materiality is so important is for its implications for preparers of financial statements and auditors. In fact, International Financial Reporting Standards (IFRS) presumes that compliance with IFRS results in financial statements achieving fair presentation of the financial position, financial performance, and cash flows of an entity. IFRS compliance means that the financial statements adhere to all the requirements of IFRS. The notes must state an explicit and unreserved statement to this respect. Any departure from IFRS requirements would undermine such compliance of the whole financial statements, unless:

1. the management concludes and discloses that in an extremely rare circumstance compliance with IFRS would be so misleading to conflict with the objective of the financial statements specified in the Framework;
2. applying an IFRS requirement has a material effect, but the IASB has explicitly provided for an impracticability exception (for its meaning, see Paragraph 1.n below), and the company is in such an impracticability situation and gives the specific disclosures as required;
3. applying an IFRS requirement has a material effect, but the IASB has explicitly provided an exception based on an undue cost and effort basis (for its meaning, see Paragraph 1.m below);
4. the entity does not provide a specific disclosure required by the IFRS or does not apply a required accounting policy or does not correct an error, because such information or the

effects of applying the policy or the error is immaterial. However, the entity cannot use this argument if it does so to achieve a particular presentation of the financial position, financial performance, or cash flows (IASB, 2014, IAS 8, paras. 8, 41, BC24; IASB, 2016, IAS 1, paras. 15, 16, 19, 31, BC36).

The first situation would be extremely rare. The second and third situations are strictly defined by the IASB, not by preparers. Therefore, the management can only resort to a materiality argument to avoid a departure from Generally Accepted Accounting Principles (GAAP) having serious consequences. Paragraph V.9.a below discusses immaterial misstatements.

An entity that describes its financial statements as prepared in conformity with US generally accepted accounting principles must also apply all relevant authoritative accounting pronouncements. This concept is similar to compliance to IFRSs. US GAAP does not explicitly require a statement of compliance, as compliance is ordinarily taken for granted. Although it does not mandate an exact placement, it encourages a separate section before the notes or as a first note (FASB, 1993, FASB Interpretation no. 40, paras. Summary, 2, 5, 16; FASB, 2016, FASB ASC 235-10-05-3, 235-10-50-1, 235-10-50-6). However, US GAAP does not have an overriding case as described in the first point above. US GAAP also has some exceptions due to impracticability or undue cost or effort.

Symmetrically, auditors express an opinion on the financial statements to present fairly the financial position, financial performance, and cash flows of the entity, but they attest that this holds true in all *material* respects. Drawing a line on what is material permits auditors, on one hand, to assess and respond to financial statements compliance with GAAP and, on the other hand, defend themselves against claims concerning their audit work.

2. Powerful and Dangerous

Formally, materiality is assessed from the eyes of the users of financial statements, yet the management decides it. What lenses does the management use? If challenged, the management can easily say that an item is not material and in most occurrences a different opinion would likely be subjective as that of the management.

Readers of financial statements cannot be aware of something that is not recognized, not measured, or not presented if this fact is not disclosed. They cannot be aware of something that is not disclosed.

In theory, the management would be able to justify virtually everything based on materiality, also because a fact cannot be challenged until another party becomes aware of it. If this happens, the management would be most of the time able to discharge its liability on the grounds of professional judgment.

From all these perspectives, it is evident why a loose concept of materiality is powerful but dangerous at the same time. It presupposes a high level of maturity of management and a strong sense of business ethics, a solid system of checks and balances in corporate governance, and an effective regulatory enforcement.

3. The Disclosure Framework

Much of the recent development on materiality takes its origin from the Disclosure Framework project (FASB, 2012, File no. 2012-220). The FASB added this project in its agenda in July 2009 and issued an Invitation to Comment in 2012. It pursued a field study in 2013.

The FASB and the AICPA's Center for Audit Quality-sponsored forums on financial statement disclosure effectiveness at Columbia University's Center for Excellence in Accounting and Security Analysis on October 4, 2012 and at Stanford University Graduate School of Business on October 8, 2012 (Center for Audit Quality, 2012).

Several organizations have contributed with their independent analyses and studies, including the EFRAG, the IAASB, the ASB, the FRC, the ICAEW, the CPA Institute, and others as mentioned in several sections of this book.

Concurrently, the FASB is carrying out the Simplification Initiative, which consists in a series of a narrow-scope short-term project to simplify accounting standards and reduce their cost and complexity. The current projects include:

- Balance Sheet Classification of Debt;
- Nonemployee Share-Based Payment Accounting Improvements;
- Accounting for Financial Instruments — Hedging;
- Liabilities and Equity — Targeted Improvements.

4. The Disclosure Initiative

In the IASB's world, the Disclosure Initiative is the analog to the Disclosure Framework. Regarding materiality, the project has produced certain amendments to IAS 1 and the Practice Statement on materiality. Further discussion on the definition of materiality is expected to be part of the Principles of Disclosure project within the Disclosure Initiative.

Both the FASB's Disclosure Framework and the IASB's Disclosure Initiative projects intent to improve the overall disclosures and the notes to the financial statements through enhanced effectiveness of information. It can be argued that this is the underlying motif of every system of information, and in fact virtually all financial reporting standards and management reporting systems worldwide deal with sorting out a hierarchy of qualities of accounting and financial information. Materiality is only one of several aspects treated in the Disclosure Initiative, centered into the difficulties in applying materiality in practice which have been mostly portrayed as a conduit to ineffective disclosure (IASB, 2017, PS 2, para. BC2).

Unlike the position of the FASB, where the impossibility to arrive to an accounting definition of materiality would likely cut any further discussion short, the IASB anticipated that this will not significantly affect the short-term conclusions drawn in the IASB (2017), PS 2 (IASB, 2017, PS 2, para. BC15).

5. The Disclosure Effectiveness Initiative

The Disclosure Effectiveness Initiative is a review by the SEC Staff of disclosure requirements, their presentation and delivery as required by the Jumpstart Our Business Startups Act. In December 2013, the SEC issued a Staff Report to Congress about the review of its disclosure requirements in Regulation S-X and Regulation S-K to facilitate timely and material disclosures. The Fixing America's Surface Transportation Act (2015) required the SEC to carry out a study on the modernization and simplification of the disclosure requirements in Regulation S-K.

Several documents have been issued in this context, including:

- SEC Staff's Report on Review of Disclosure Requirements in Regulation S-K — "S-K Study" (The US Securities and Exchange Commission [SEC], 2013);
- SEC Release no. 33-10064, Business and Financial Disclosure Required by Regulation S-K, April 13, 2016 (SEC, 2016);
- SEC Release no. 33-10110, Proposed Rule, Disclosure Update and Simplification, July 13, 2016 (SEC, 2016);
- Report on Modernization and Simplification of Regulation S-K, November 23, 2016.

On September 25, 2015, the SEC announced that it is seeking public comment on the effectiveness of financial disclosure of Regulation S-X. So far, this has produced the Release no. 33-9929, *Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant*, September 25, 2015. The SEC will also review the differences and possible ways of aligning the disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, working with the FASB to address overlapping requirements in US GAAP and SEC rules, and improve the delivery and navigability of information through technology.

Some of other prior documents on the topic include:

- Report of the Task Force on Disclosure Simplification, March 5, 1996;
- Report of the Advisory Committee on the Capital Formation and Regulatory Processes, July 24, 1996;
- Final Report of the Advisory Committee on Improvements to Financial Reporting in the United States Securities and Exchange Commission, August 1, 2008.

6. Objectives of the Book

The objective of this book is twofold. First, it intends to review the different angles of the literature of materiality and integrate them into an overall systemic perspective. Second, the book proposes new ways of looking at materiality that originate from the above integration of diverse existing disciplines. This entails the consideration of accounting standards, auditing standards, internal control over financial reporting, management commentary, financial analysis and management control, forensic analysis, sustainability reporting, corporate responsibility, assurance standards, integrated reporting, and limited legal considerations.

To accomplish the first objective, the book deals with both theory and practice. It pursues a theoretical analysis of the conceptual frameworks and of the definitions of materiality. It compares the actors involved in materiality decisions and their roles. On the practice side, it analyzes existing guidance on the application and assessment of materiality and contrasts it to identify gray areas. It shows real-world illegitimate uses of materiality to misstate financial results.

To achieve the second objective, the book first creates a taxonomy of the materiality attributes that are embedded in the different definitions. Then it elaborates the existing views to materiality or creates new ones, to show that this subject can be seen from different angles and applied to different contexts. It proposes attention to the unstated recognition and measurement problems of materiality and the often-found hidden agenda of management in manipulating financial results. It shows the leading practice of zero materiality in bookkeeping and advocates a good faith approach in genuinely separating the understanding of users' perspective from applying the highest standard of due diligence in accounting practice. In integrating disciplines that are generally seen separately, it derives practical suggestions on how to assess and judge materiality, and explains how the management can reuse tools that other actors, such as auditors or regulators, adopt to address materiality issues. Finally, it makes a systematic reorganization of materiality determination processes and leading practice that are at the forefront of future developments.