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Comments to IFRS Practice Statement: Application of Materiality to Financial Statements

Japan Leasing Association

The Japan Leasing Association ("the JLA"), while offering numerous comments to date in connection with the deliberations on the Leases Project, has been making a particularly strong case for the application of materiality.

In practice, it is extremely difficult for management (preparers of financial statements) to appropriately assess materiality, and determine whether the presentation of the financial statements, the contents of the disclosures and the recognition and measurement requirements of IFRS conform to such materiality.

Therefore, the JLA highly commends the release by IASB of the [draft] Practice Statement as a way of assisting management in applying the concept of materiality.

However, in order for management to apply the concept of materiality with ease; in other words, for this Practice Statement to become practicable, the JLA recommends improvements to the [draft] Practice Statement as per the Attachment. A summary of the recommendations follows.

<Executive Summary>

I. In order to achieve the objectives of assisting management in applying the concept of materiality and influencing changes in the current situation of dependence on judgments based on checklists, a Practice Statement is necessary that allows auditors to accept management's judgment, which has been made in accordance with the guidance.

II. The Practice Statement should maintain fairness between the descriptions, guidance and illustrative examples of material cases and the descriptions, guidance and illustrative examples of immaterial cases, and should also contain an executive summary, which clearly and comprehensively summarizes the guidance to ensure that it is sufficiently understood by management and that it facilitates management in applying the concept of materiality.

III. In practice, the application of the concept of materiality is expected to be conducted by first passing judgment on whether the effect of not applying recognition and measurement requirements is material and subsequently deciding whether to apply the concept of materiality in the presentation and disclosure of information in the financial statements. Consequently, a statement should be placed at the beginning of the section on 'Recognition and Measurement' that the recognition and measurement requirements of IFRS need not be applied if the effect of not applying them is not material.

IV. The Practice Statement should ensure that, when conducting preliminary assessments using quantitative thresholds to determine whether the effect of not applying recognition and measurement requirements is material, the auditors will not impose excessively rigid judgment criteria, such as the need to conduct exhaustive comparisons of the differences arising if recognition and measurement were conducted in accordance with the IFRS requirements as opposed to performing accounting treatment in accordance with the standards to be adopted, that would inhibit the application of the concept of materiality.

V. The [draft] Practice Statement should include useful and practical examples regarding the application methods of the concept of materiality as well as the methods of judgment on the concept of materiality to be used by management in its decision making. On the other hand, examples that could elicit misjudgments from management regarding the application of the concept of materiality should be deleted, revised or replaced with other examples.

【Attachment】

I. In order to achieve the objectives of assisting management in applying the concept of materiality and influencing changes in the current situation of dependence on judgments based on checklists, a Practice Statement is necessary that allows auditors to accept management's judgment, which has been made in accordance with the guidance.

1. The Practice Statement sets out its objective as assisting management in applying the concept of materiality (Paragraph 1), while the guidance in the [draft] Practice Statement is expected to help in influencing positive changes in behavioral issues such as rigid adherence to checklists when preparing financial statements (BC24).

2. In practice, when preparing financial statements, a key factor hindering the application of the concept of materiality is the difference in judgment between management and the auditors. Under normal circumstances, auditors should use the same principles as management to make judgements regarding the application of the concept of materiality when expressing opinion on all material aspects of the financial statements. However, as stated in BC7, management has been resorting to the preparation of financial statements, which include immaterial as well as material information rather than spending the time and costs of justifying to the auditors who hold different opinions the removal of immaterial information, in an effort to avert the risk of preparing financial statements containing opinions that differ from the auditors.

3. Therefore, in order to achieve the objectives of assisting management in applying the concept of materiality and influencing changes in the current situation of dependence on judgments based on checklists, a Practice Statement is necessary that allows auditors to accept management's judgment, which has been made in accordance with the guidance.

4. One method of achieving this end would be to include in the main text (in the paragraph on the Objective) as well as in the BC, a statement to the effect that the Practice Statement could be used as reference in making judgments on the application of materiality when auditors express their opinions on all material aspects of financial statements, in addition to the objective of assisting management in applying the concept of materiality.

5. We look forward to the prompt release of the Practice Statement and its pervasive use through such means as briefings held for the preparers and users of financial statements, auditors and other related parties.

II. The Practice Statement should maintain fairness between the descriptions, guidance and illustrative examples of material cases and the descriptions, guidance and illustrative examples of immaterial cases, and should also contain an executive summary, which clearly and comprehensively summarizes the guidance to ensure that it is sufficiently understood by management and that it facilitates management in applying the concept of materiality.

6. It is our understanding that the Practice Statement will provide guidance that will enable management to include material information while omitting immaterial information, as necessary, when preparing financial statements. However, the contents of the [draft] Practice Statement indicate a bias towards descriptions, guidance and examples of material cases.

7. Therefore, the contents of the Practice Statement should be such that it fairly presents the descriptions, guidance and examples of both material and immaterial cases.

8. Meanwhile, there are concerns as to whether management will be able to appropriately apply the concept of materiality in accordance with the guidance contained in the Practice Statement, as the guidance section of the [draft] Practice Statement is interspersed with statements from the description section.

9. Therefore, the Practice Statement should contain an executive summary, which clearly and comprehensively

summarizes the guidance to ensure that it is sufficiently understood by management and that it facilitates management in applying the concept of materiality. By including an executive summary of the guidance, achievement of the objective of the Practice Statement to “assist management in applying the concept of materiality” is expected to become more likely.

III. In practice, the application of the concept of materiality is expected to be conducted by first passing judgment on whether the effect of not applying recognition and measurement requirements is material and subsequently deciding whether to apply the concept of materiality in the presentation and disclosure of information in the financial statements. Consequently, a statement should be placed at the beginning of the section on ‘Recognition and Measurement’ that the recognition and measurement requirements of IFRS need not be applied if the effect of not applying them is not material.

10. The [draft] Practice Statement provides guidance in the three main areas of ‘general characteristics of materiality,’ ‘presentation and disclosure of financial statements,’ and ‘omissions and misstatements (collectively referred to as “misstatements”)’ (IN4). Additionally, while much of the contents of the [draft] Practice Statement focuses on providing guidance on the application of materiality when presenting and disclosing information, similar considerations also apply to the ‘Recognition and measurement’ of information (Paragraph 61).

Recognition and measurement

61 Much of the content of this [draft] Practice Statement focusses on providing guidance on the application of materiality when presenting and disclosing information in the financial statements. However, similar considerations also apply to the recognition and measurement of the information that is provided in the financial statements.

11. Nevertheless, there are only a few sections relating to the application of materiality in the ‘Recognition and measurement’ (Paragraphs 30, 31, 34 and 35) among the statements relating to the ‘Presentation and disclosure of financial statements.’

12. In the deliberations on the Leases Project the JLA has indicated the status of operating leases in Europe, the US and Japan and explained that there is only a limited number of entities in which users of financial statements would benefit from the changes in the lease accounting standards and that for many entities, the impact of operating leases on financial statements is extremely limited.

13. Once IFRS 16 Leases (new Leases Standard) is effective, many of the entities who believe that the amount of leases will not impact their financial statements will refer to the guidance in the Practice Statement and make judgment on whether to conduct recognition and measurement as required in IFRS 16 Leases.

14. In this way, the application of the concept of materiality, in practice, is expected to be conducted by first passing judgment on whether the effect of not applying recognition and measurement requirements is material and subsequently deciding whether to apply the concept of materiality in the presentation and disclosure of information in the financial statements. Consequently, a statement should be placed at the beginning of the section on ‘Recognition and measurement’ that the recognition and measurement requirements of IFRS need not be applied if the effect of not applying them is not material.

15. The JLA recommends that Paragraph 61 be revised as per the following, while at the same time revising the contents of Paragraphs 30, 31, 34, and 35 to align with the application of materiality in recognition and measurement, and to include such contents in ‘Recognition and measurement.’

Recognition and measurement

61 ~~Much of the content of this [draft] Practice Statement focusses on providing guidance on the application of materiality when presenting and disclosing information in the financial statements. However, similar considerations also apply to the recognition and measurement of the information that is provided in the financial statements.~~ It is not necessary to apply the IFRS requirements, if the effect of not applying them is not material. The same applies to the recognition and measurement requirements (see Paragraph 11).

16. Furthermore, as existing Paragraph 64 relates more to the materiality of recognition and measurement rather than to 'Practical expedients' of Paragraphs 63 through 66, it should be stated together with Paragraph 61. Additionally, we propose the addition of an example of a specified threshold, as well as moving the sentence, "Such a policy …appropriate," to the end of the Paragraph, in order to facilitate the flow of the sentence, as per the following.

64 An entity might have an internal policy of capitalizing capital expenditures only in excess of a specified threshold and recognizing ~~smaller~~ amounts <u>that fall below such threshold</u> as an expense, because any ~~smaller~~ amounts <u>falling below such threshold</u> are considered to be clearly immaterial. <u>For example, a lessee in a lease might make judgment that the recognition and measurement requirements set forth in IFRS 16 Leases do not apply since the ratio of the total amount of leases to the financial statements falls below the specified ratio.</u> Management has assessed that this departure from IFRS is unlikely to have a material effect both on the current financial statements and in future financial statements, because it is clear such expenditure could not reasonably be expected to influence decisions made by the primary users. ~~Such a policy should nevertheless be reassessed periodically to ensure that these assumptions remain appropriate.~~ Provided that such a practice does not have a material effect on the financial statements, it would not prevent the entity's financial statements from complying with IFRS. <u>Such a policy should nevertheless be reassessed periodically to ensure that these assumptions remain appropriate</u> (see also paragraphs 77–79).

17. The first half of existing Paragraph 62 describes cases in which the effects of recognition and measurement are material, while the second half describes errors in presentations and is unrelated to the first half. Therefore, Paragraph 62 should be revised in order to make the general meaning more comprehensible.

62 IFRS recognition and measurement requirements are applied if their effect is material to the financial statements. In particular, IAS 8 states that financial statements do not comply with IFRS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

IV. The Practice Statement should ensure that, when conducting preliminary assessments using quantitative thresholds to determine whether the effect of not applying recognition and measurement requirements is material, the auditors will not impose excessively rigid judgment criteria, such as the need to conduct exhaustive comparisons of the differences arising if recognition and measurement were conducted in accordance with the IFRS requirements as opposed to performing accounting treatment in accordance with the standards to be adopted, that would inhibit the application of the concept of materiality.

18. The JLA agrees with the statement in Paragraph 26, "While quantitative thresholds are not in themselves determinative, they can be a helpful tool in applying the concept of materiality." The statement, "A quantitative threshold may provide the basis for a preliminary assessment that an amount is likely to be material or immaterial," is also understandable.

26 However, while quantitative thresholds are not in themselves determinative, they can be a helpful tool in applying the concept of materiality. A quantitative threshold may provide the basis for a preliminary assessment

that an amount is likely to be material or immaterial; for example if it is below a specified percentage of profit or net assets. However, a materiality assessment also requires consideration of the nature of the item and the entity's circumstances.

19. However, when conducting assessments on whether the effect of not applying recognition and measurement requirements is material using quantitative thresholds, if we were required to conduct exhaustive comparisons of the differences arising if recognition and measurement were conducted in accordance with the IFRS requirements as opposed to performing accounting treatment in accordance with the standards to be adopted, we would need to spend additional costs and time in order to justify an amount as being immaterial.

20. As a result, as stated in BC7, the conditions that are no different from current practices will continue, i.e. management has been resorting to the preparation of financial statements, which include immaterial as well as material information rather than spending the time and costs of justifying to the auditors who hold different opinions the removal of immaterial information, in an effort to avert the risk of preparing financial statements containing opinions that differ from the auditors.

21. BC 23 states, "the expected effect of the proposed guidance is a better understanding and application of materiality without any significant cost for management."

22. Therefore, when conducting assessments on whether the effect of not applying recognition and measurement requirements is material using quantitative thresholds, in order to ensure that the auditors will not impose excessively rigid judgment criteria that would inhibit the application of the concept of materiality, the following statement should be added in connection with Paragraph 26.

> " When conducting preliminary assessments on whether the effect of not applying recognition and measurement requirements is material using quantitative thresholds, it is not necessary to conduct exhaustive comparisons of the differences arising if recognition and measurement were conducted in accordance with the IFRS requirements as opposed to performing accounting treatment in accordance with the standards to be adopted. For example, it would suffice to simply provide a reasonable explanation that the decisions of the users of the financial statements will not be influenced by the scope that has been determined to be immaterial or by the accounting treatment to be adopted for such scope."

V. The [draft] Practice Statement should include useful and practical examples regarding the application methods of the concept of materiality as well as the methods of judgment on the concept of materiality to be used by management in its decision making. On the other hand, examples that could elicit misjudgments from management regarding the application of the concept of materiality should be deleted, revised or replaced with other examples.

23. The [draft] Practice Statement should include useful and practical examples regarding the application methods of the concept of materiality as well as the methods of judgment on the concept of materiality to be used by management in its decision making. Additionally, the [draft] Practice Statement should incorporate both cases, i.e. 'material cases' and 'immaterial cases' in each example, thereby deepening the understanding of what is meant by materiality and allowing management (preparer of the financial statements) and the auditors to make reasonable judgments. The [draft] Practice Statement contains illustrative examples and points to note in cases where materiality exists but offers little clarity regarding cases that are not material, thus raising concerns of the possibility of the former cases being exclusively emphasized by the auditors in practice.

24. Meanwhile, examples that are not consistent with the IFRS and examples that will not deepen the understanding of the guidance may elicit misjudgments from management regarding the application of the

concept of materiality and thus should be deleted. If such examples are not to be deleted, they should be revised or replaced by another example, or justification should be provided as to why such an example is presented.

25. For example, the example, which focuses on 'qualitative characteristics,' given in Paragraph 39 (a) has the potential to elicit misjudgments from management regarding the application of the concept of materiality.

> 39
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> (a) if an entity has 500 similar leases of similar assets, then combining them together for disclosure purposes may not lead to a loss of material information. However, if a subset of those 500 leases has significantly different characteristics from the others (such as residual value guarantees or extension options), separate information about that subset may be material.

26. IFRS 16 Leases requires right-of-use assets and lease liabilities to be presented separately in the statement of financial position or disclosed in the notes. Residual value guarantees and extension options that are reasonably certain to be exercised are to be presented by inclusion in such right-of-use assets and lease liabilities.

27. For this reason, it cannot be assumed that the leases with residual value guarantees and the leases with extension options among the right-of-use assets and lease liabilities included in ~~the~~ assets and liabilities in the statement of financial conditions, or ~~the~~ right-of-use assets and lease liabilities presented separately in the statement of financial condition would have any markedly different characteristics compared to the other leases.

28. However, by including an example such as the example in Paragraph 39 (a), entities will be forced to present right-of-use assets and lease liabilities separately in the statement of financial condition and thereupon make materiality judgments on leases with residual value guarantees and extension options. Furthermore, if they are found to be material, entities will also need to deliberate whether to present them separately or disclose them in the notes.

29. Nowhere is it assumed that leases with residual value guarantees and extension options have markedly different characteristics compared to other leases and nowhere in IFRS 16 Leases are leases with residual value guarantees and extension options required to be explicitly disclosed. Therefore, Paragraph 39 (a) which focuses on qualitative characteristics is inappropriate as an example to deepen the understanding of the guidance and could also elicit misjudgments from management regarding the application of the concept of materiality, and thus should be deleted.

30. Additionally, as 'an immaterial case,' examples such as the following underlined example should be incorporated into Paragraph 79.

> 79 For example, there is a difference between:
>
> (a) management deciding not to discount a liability to reflect the time value of money because there is no material difference between the discounted and non-discounted value, and
>
> (b) management deliberately choosing to use an inappropriate discount rate in order to reduce the amount of the liability.
>
> <u>When an entity discounts a liability in an excessively low-interest rate environment and there is no materiality to the discounted financial liability, the liability may alternately be measured at the undiscounted amount; or interest may be calculated using the straight-line method instead of the interest method upon recognizing the financial liability at the discounted amount. Meanwhile,</u> a deliberate choice by management to use an inappropriate discount rate would be material because management is presumably doing so in order to 'achieve a particular presentation of an entity's financial position, financial performance or cash flows.'