

MATERIALITY IN FINANCIAL REPORTING

An Integrative Perspective

This page intentionally left blank

MATERIALITY IN FINANCIAL REPORTING

An Integrative Perspective

BY

FRANCESCO BELLANDI



United Kingdom – North America – Japan
India – Malaysia – China

Emerald Publishing Limited
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2018

Copyright © 2018 Emerald Publishing Limited

Reprints and permissions service

Contact: permissions@emeraldinsight.com

No part of this book may be reproduced, stored in a retrieval system, transmitted in any form or by any means electronic, mechanical, photocopying, recording or otherwise without either the prior written permission of the publisher or a licence permitting restricted copying issued in the UK by The Copyright Licensing Agency and in the USA by The Copyright Clearance Center. Any opinions expressed in the chapters are those of the authors. Whilst Emerald makes every effort to ensure the quality and accuracy of its content, Emerald makes no representation implied or otherwise, as to the chapters' suitability and application and disclaims any warranties, express or implied, to their use.

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN: 978-1-78743-737-1 (Print)

ISBN: 978-1-78743-736-4 (Online)

ISBN: 978-1-78743-843-9 (Epub)



ISOQAR certified
Management System,
awarded to Emerald
for adherence to
Environmental
standard
ISO 14001:2004.

Certificate Number 1985
ISO 14001



INVESTOR IN PEOPLE

To Anna, constant presence and support

This page intentionally left blank

Contents

List of Figures	<i>xix</i>
About the Author	<i>xxv</i>
Preface	<i>xxvii</i>
Part I. Introduction and Background	1
Main Focus of Part I	2
1. Why Does Materiality Matter in Financial Statements?	2
2. Powerful and Dangerous	3
3. The Disclosure Framework	4
4. The Disclosure Initiative	5
5. The Disclosure Effectiveness Initiative	6
6. Objectives of the Book	7
Part II. Conceptual Bases of Materiality	9
Main Focus of Part II	10
1. Materiality in the Conceptual Frameworks	10
1.a. The Objective of Materiality	10
1.b. Level of Interaction in the Conceptual Frameworks	10
1.c. A Pervasive Concept or a Qualitative Characteristic?	11
1.d. Is Materiality a Constraint?	15
1.e. Interaction with Qualitative Characteristics of Accounting Information	16
1.f. Materiality versus Relevance	16
1.g. Entity Specificity	20
1.h. Materiality versus Reliability and Faithful Representation	22
1.i. Completing the Picture: Materiality versus Completeness	24
1.j. Materiality versus Understandability	25

1.k. Does Prudence or Neutrality Affect Materiality?	27
1.l. The Link to Recognition in the Conceptual Frameworks	28
1.m. Cost/Benefit Constraint versus Materiality	30
1.n. Impracticability versus Materiality	30
1.o. Significance	31
2. Definitions of Materiality	33
2.a. Can a Definition of Materiality Be Given?	33
2.b. Summary of Definitions	39
2.c. US Supreme Court's Definition	39
2.d. FASB (1985), CON 2	40
2.e. SEC Rules and Regulations	41
2.f. Common Law	43
2.g. IASB Framework	43
2.h. Common Conceptual Framework	43
2.i. The International Financial Reporting Standards	44
2.j. Auditing Standards	45
2.k. COSO Framework	45
2.l. AccountAbility	46
2.m. Integrated Reporting	46
2.n. WRI and WBCSD	46
3. Attributes of Materiality	47
3.a. Subject Matter	47
3.b. What Is an Item?	47
3.c. An Item versus Its Content	48
3.d. Omissions or Misstatements	49
3.e. Material Disclosures of An Item versus Its Required Disclosures	50
3.f. Materiality Test from Users' Perspective	50
3.g. Materiality Test Contrasted with the Objective of General-Purpose Financial Statements	51
3.h. Materiality Test from the Standpoint of Objective Metrics	52
3.i. Addressees of Test	52
3.j. Reasonable Investor and Reasonable Person	52
3.k. Clusters versus Individuals	53
3.l. Primary versus Intended versus Other Users	53
3.m. Stakeholders versus Users	54
3.n. Assessor	55
3.o. Degree of Likelihood	55
3.p. Understanding Influence versus Influencing	57
3.q. Degree of Magnitude	59
3.r. Context	59

3.s. Degree of Specificity	60
3.t. Time Horizon	60
Solutions and Recommendations	61
Conclusion	67
Part III. Actors and Models of Materiality	69
Main Focus of Part III	70
1. Uses and Effects of Materiality	70
1.a. Is Materiality Exclusively a Legal Concept?	70
1.b. Are Legal and Accounting Definitions of Materiality Incompatible?	71
1.c. Practical Interactions of Legal and Accounting Concepts of Materiality	73
1.d. The Different Nature of an Accounting Concept of Materiality	74
1.e. The Quest for an Accounting Definition of Materiality	75
1.f. Materiality in Audit versus in Financial Statements	76
1.g. Other Uses of Materiality by Auditors	77
1.h. Materiality as a Managerial Concept	79
2. Who Decides about Materiality?	79
2.a. Who Allows Materiality?	79
2.b. Who Uses Materiality?	80
2.c. Who Decides Materiality?	80
2.d. Who Assesses Materiality?	81
3. Models of Materiality	82
3.a. Do We Need a Framework of Materiality?	82
3.b. A Positive versus a Negative Concept	82
3.c. A Discrete versus a Continuous Notion	83
3.d. Different Disclosure Regimes	85
3.e. Simulating User Decision Model	86
3.f. Probability/Magnitude Mapping	86
3.g. Severity of Deviancies	90
3.h. Range of Fluctuation	91
3.i. Opportunity Loss	91
3.j. Statistical Use of Information	91
3.k. Doctrine of Differential Disclosure	92
3.l. Expanded Dimensions of Materiality	95
3.m. The Flexibility Zone	97
3.n. Eyes of Management versus Eyes of Investors	98
3.o. The Ownership Triangle	100
3.p. Active versus Passive Role	101
3.q. The Sender–Receiver Distortion	102

3.r. U-Materiality	103
3.s. Objective versus Subjective Determination	103
3.t. Materiality as a Planning Tool	104
3.u. Consensus Materiality	104
3.v. Adjustment Method	105
3.w. From Materiality to Materiality Determination Process	106
3.x. Qualitative Factors	106
3.y. Zero Materiality	107
Solutions and Recommendations	107
Conclusion	112
Part IV. Application of Materiality	113
Main Focus of Part IV	114
1. Materiality Applied to Recognition and Measurement	114
1.a. Does Materiality Apply to Recognition and Measurement?	114
1.b. Inapplicability by Analogy	115
1.c. De Minimis	115
1.d. Significant Accounting Policies	115
1.e. Accounting Policies with Immaterial Effects	117
1.f. Scope of a Change in Accounting Policies	117
1.g. Materiality in Disclosing Voluntary Changes in Accounting Policies	117
1.h. Materiality in Disclosing Involuntary Changes in Accounting Policies	118
1.i. The Case of Accounting Errors	119
2. Materiality Applied to Presentation and Disclosure	120
2.a. Does Materiality Apply to Presentation and Disclosure?	120
2.b. An Item versus Information of An Item	122
2.c. Required Disclosure of Immaterial Information	122
2.d. Allowed Disclosure of Immaterial Information	123
2.e. The Disclosure Overload Debate	124
2.f. Obscuring Material Information	125
2.g. Minimum Set of Required Disclosures	126
2.h. Classification	127
2.i. Interaction of Aggregation and Disaggregation of Information	128
2.j. Top-down Model of Disaggregation in the Financial Statements	129
2.k. Bottom-up Model of Aggregation in the Financial Statements	130

2.l.	Classes of Aggregation	132
2.m.	Alternative Model of Aggregation in the Financial Statements	133
2.n.	General Models of Disaggregation for Disclosure Purpose	134
2.o.	Review Assessment	137
2.p.	Quality of Disclosure	138
2.q.	Material Items	138
2.r.	Disclosure Objectives	139
2.s.	Gains and Losses	140
2.t.	Effect of Measurement Bases	140
2.u.	Third Statement of Financial Position	141
2.v.	Rounding	141
2.w.	When Required Disclosure Is Not Enough	142
3.	Materiality Applied to Management Commentary	143
3.a.	Management Commentary versus the Notes	143
3.b.	Views of Materiality in Management Commentary	144
3.c.	Material Known Trends or Uncertainties in SEC's MD&A	145
3.d.	Material Changes	149
3.e.	Critical Accounting Estimates in MD&A	149
3.f.	Immaterial Information in MD&A	150
3.g.	Segment Analysis	150
3.h.	Layered Disclosure	151
4.	Does Materiality Apply to Bookkeeping?	151
4.a.	Bookkeeping versus Financial Statements: A Separate Perspective	151
4.b.	Bookkeeping versus Financial Statements: An Integrated Perspective	152
4.c.	The Direct Impact on Financial Statements of Bookkeeping Errors	153
4.d.	The Indirect Impact on Financial Statements of Bookkeeping Errors	153
4.e.	The Delicate Link to Intentional Immaterial Errors	154
4.f.	Immaterial Misstatements versus Bookkeeping Errors	155
4.g.	Can Immaterial Bookkeeping Errors Be Left Uncorrected?	155
4.h.	Does Materiality Apply to Bookkeeping?	156
4.i.	Reasonableness versus Materiality	156
4.j.	Legal Implications	157
4.k.	Should Accountants Care of Materiality at All?	158
5.	Materiality in Auditing	159
5.a.	Audit Definition of Materiality	159

5.b.	Definition of Material Misstatement	160
5.c.	The Risk of Material Misstatements and Assertions	161
5.d.	Relationship between Audit Risk and Materiality	162
5.e.	Iteration of Materiality and Inherent Risk	165
5.f.	Second-Guessing Management's Determination of Users' Needs	166
5.g.	Timing of Auditor's Consideration of Materiality	166
5.h.	Undetected, Identified, Uncorrected, and Corrected Misstatements	168
5.i.	How Materiality Affects Auditors' Responses to Misstatements	168
5.j.	How Materiality Affects Auditors' Responses to Fraud	169
5.k.	How Materiality Affects Auditors' Responses to Illegal Acts	170
5.l.	Communications with the Management, Internal Auditors, and Audit Committee	171
6.	Materiality Applied to Internal Control Over Financial Reporting	172
6.a.	Internal Control over Financial Reporting versus Audit	172
6.b.	Materiality and Technical Classifications of Internal Control Deficiencies in SOX	173
6.c.	Materiality and Internal Control Deficiencies in COSO Framework	174
6.d.	Materiality in PCAOB Audit Standard for ICOFR	175
6.e.	Definition of Risk	175
6.f.	Risk Tolerance	176
6.g.	Risk Appetite	177
6.h.	Risk Appetite and Risk Tolerance in the Context of Corporate Guidance Systems	177
6.i.	Interlock of Risk, Risk Appetite, Risk Tolerance, and Precision of Internal Controls	178
6.j.	Relationship between Risk Tolerance and Materiality	180
6.k.	Planned Materiality versus Risk Tolerance and Performance Materiality	181
6.l.	Relationship between Risk Tolerance and Precision of Controls	181
6.m.	Inherently Imprecise Controls	183
6.n.	Other Drivers of the Precision of Controls	183
6.o.	The Importance of Immaterial Misstatements in ICOFR	184
6.p.	Documentation of Determination of Immateriality	185
6.q.	Role of Materiality in Testing ICOFR	185
6.r.	Management Review Controls	186

Solutions and Recommendations	187
Conclusion	197
Part V. Assessing Materiality	199
Main Focus of Part V	200
1. Types of Assessment and Professional Judgment	200
1.a. Quantitative versus Qualitative Criteria	200
1.b. Is Quantitative an Assurance?	202
1.c. Is Magnitude Exclusively a Quantitative Concept?	202
1.d. What Is the Meaning of Qualitative?	203
1.e. When a Qualitative Assessment Is Always Required	204
1.f. When a Fact Is Always Material	204
1.g. Management Discretion	208
1.h. Auditor and Other External Professional Judgment	210
1.i. How Can the Management Judgment Be Professional?	211
1.j. What Is the Scope of Professional Judgment?	212
1.k. Who Is a Professional Judge?	213
1.l. When Is the Judgment Process Professional?	213
1.m. Documentation of Judgment	214
1.n. How to Evaluate Judgment Reasonableness?	214
1.o. Changes in Judgment and Reassessment	216
2. Quantitative Thresholds of Materiality	217
2.a. Thresholds for Whom?	217
2.b. Role of Quantitative Thresholds	217
2.c. The Case of an Absolute Dollar Amount	218
2.d. When a Relatively Small Misstatement May Be Material	219
2.e. When a Large Misstatement Can Be Immaterial	219
2.f. Performance Materiality	221
2.g. The Adjustment Method	223
2.h. Process Analysis of Materiality	223
2.i. Should the Management Use Materiality Set by Auditors?	223
3. Levels of Application of Materiality	224
3.a. The Concept of Whole Financial Statements	224
3.b. Periods of Whole Financial Statements	225
3.c. Materiality at Lower Levels	225
3.d. Consolidated versus Entity or Separate Financial Statements	227
3.e. Component Materiality	227
4. Benchmarks	231
4.a. Common Benchmarks	231

4.b.	Relative versus Absolute Measures	232
4.c.	Rules of Thumbs Used in Practice	232
4.d.	Choosing Benchmarks	234
4.e.	Normalizing Benchmarks	235
4.f.	Deciding Percentages	236
4.g.	Volatility	236
4.h.	Industry Type	237
4.i.	Capital Structure	237
4.j.	Company Life Cycle	238
4.k.	Pervasiveness	238
4.l.	Degree of Aggregation	239
5.	Comparative Information	239
5.a.	Basic Period in Focus	239
5.b.	Materiality in Prior Period	240
5.c.	Corresponding Figures versus Comparative Financial Statements Approach	240
5.d.	Third Statement of Financial Position	243
5.e.	Materiality in Future Periods	243
5.f.	Uncorrected Immaterial Misstatements Adding Up to Materiality in the Current Period	244
5.g.	Effect of Changes of Materiality Benchmarks	250
5.h.	Effect of Misstatement of Comparative Information	250
5.i.	Counterbalancing and Noncounterbalancing Misstatements	251
5.j.	Structure of the Notes	252
5.k.	Effect on Financial and Forensic Analysis	252
6.	Estimates	253
6.a.	Risk of Material Misstatement of an Accounting Estimate	253
6.b.	Inherent Level of Imprecision of an Accounting Estimate	254
6.c.	The Linkage between Estimation Uncertainty and Materiality	254
6.d.	Judgmental Misstatements	256
6.e.	The Linkage between Inherent Imprecision and Misstatements	257
6.f.	Management Bias	258
6.g.	Effect of Materiality on Changes in Estimates	259
6.h.	Linkage between Materiality and Sources of Estimation Uncertainty	259
6.i.	Critical Accounting Estimates	260
6.j.	Effect on Reliability of Materiality of a Misstatement of Estimate	261

7.	Individual versus Cumulative Misstatements	261
7.a.	Analysis at Individual Item Level	261
7.b.	Analysis at a Cumulative Level	262
7.c.	Offsetting Misstatements	262
7.d.	Aggregation Technique and Absolute Value	263
7.e.	Trends and Ratios	263
8.	Verification	264
8.a.	Assessing Decisions	264
8.b.	Documentation	265
8.c.	Approaches to Verify Materiality Ex Post	265
8.d.	The Implication in Terms of Accounting Changes	266
8.e.	Methods to Assess Estimates	267
9.	Immaterial Misstatements	267
9.a.	Does GAAP Really Not Apply to Immaterial Items?	267
9.b.	Are Misstatements of Immaterial Items Errors?	269
9.c.	Intentional Immaterial Misstatements	269
9.d.	Does Intention Make a Misstatement Always Material?	270
9.e.	How to Judge Intentions?	271
9.f.	The Difference between Achieving a Particular Presentation and Influencing Users	271
9.g.	Investigating the Objective Element	272
9.h.	A Policy to Ignore Immaterial Misstatements	272
9.i.	Are Immaterial Misstatements Relevant to an Audit?	273
9.j.	Material Effect of Accumulation of Immaterial Errors	273
9.k.	Correction of Immaterial Errors	274
9.l.	Tone from the Top	275
9.m.	Legal Consequences	275
9.n.	Summary of Treatment of Errors	275
10.	Assessing Materiality in Interim Reporting	277
10.a.	Reference Period of Materiality under IFRS	277
10.b.	Reference Period of Materiality under US GAAP	278
10.c.	Materiality in Interim Reporting for Correction of Errors	278
10.d.	Materiality in Interim Reporting for Changes in Estimates and Changes in Accounting Policies	279
10.e.	Relationship between Materiality to Interim and to Annual Financial Statements	280
10.f.	Relationship between Estimation Uncertainty and Materiality in Interim Periods	281
10.g.	Materiality for the Condensed Format of Interim Financial Statements	283
10.h.	Audit Considerations	283
10.i.	Interim Periods in MD&A	284

11. Assessing Materiality in Segment Reporting	285
Solutions and Recommendations	287
Conclusion	300
Part VI. The Materiality Determination Process	301
Main Focus of Part VI	302
1. Processes and Methods	302
1.a. Linkage to the Judgment Process	302
1.b. Frameworks to Determine Materiality	302
2. Accounting-derived Approaches	303
2.a. The Qualitative Factors	303
2.b. The IASB's Four-Step Approach	303
3. Audit-derived Approaches	304
3.a. Audit Procedures	304
3.b. Audit Red Alerts	304
3.c. Materiality Benchmark Selection	310
3.d. Analytical Procedures	311
4. Risk-derived Approaches	311
4.a. Risk-Level Graphs	311
4.b. Heat Maps	311
5. Approaches Derived from Larger Frameworks	312
5.a. Materiality Determination in Integrated Reporting	312
5.b. Materiality Determination in AA1000	313
5.c. The Materiality Matrix	314
5.d. Five-Part Materiality Test	315
5.e. Significance/Influence Matrix	315
5.f. The Materiality Map	316
6. Disclosure of the Materiality Process	316
6.a. The Integrated Reporting Disclosures of the Materiality Process	316
6.b. The GRI Disclosures of the Materiality Process	317
7. Model Disclosures of Material Matters	317
7.a. General Disclosures in Accounting Standards	317
7.b. General Disclosures in Audit Standards	318
7.c. Disclosure of Material Matters in Integrated Reporting	319
7.d. Disclosure of Material Aspects in Sustainability Reporting	319
7.e. ITAC Principles-based Disclosures	320
Solutions and Recommendations	320
Conclusion	323

Part VII. Where Standard Specifically Require Materiality Judgments	325
Main Focus of Part VII	326
1. Is Materiality Standard-Specific?	326
2. What Standards Say Users Want	326
3. The Notion of Inconsequential or Perfunctory	340
4. Materiality Applied to Specific Unit of Account	341
4.a. Materiality to Assess Performance Obligations	341
4.b. Materiality of a Financing Component	341
4.c. Materiality of a Customer Option	341
5. Related Parties	341
6. Materiality Applied to Specific Items or Circumstances	345
Solutions and Recommendations	345
Conclusion	346
Part VIII. Accounting Materiality in the Real World	347
Main Focus of Part VIII	348
1. The Materiality Paradox	348
2. Improvement of the Effectiveness of Financial Statements: The Standard-Setters' View	348
3. Behavioral Issues	349
4. Is There Something Missing?	350
5. Materiality Comments on SEC Staff IFRS Reviews	351
6. Typical Materiality Abuses by Management	354
6.a. Uses and Misuses of Materiality	354
6.b. Failure to Disclose	355
6.c. Below Materiality Threshold	355
6.d. Setting Materiality High	356
6.e. Ignoring Aggregation Risk	357
6.f. Aggregated Benchmarks	357
6.g. Offset	357
6.h. Static versus Dynamic Benchmarks	358
6.i. Income Statement Orientation	358
6.j. The Presentation versus Disclosure Game	359
6.k. The Change in Materiality Game	360
6.l. Undue Cost or Effort or Impracticability	360
6.m. Contra-Asset and Provision Items	360
6.n. Income Shifting	361
6.o. Unbundling Misstatements	361

6.p. Statements Were Audited	362
6.q. Absolute Amounts	363
6.r. Too Difficult to Understand	364
6.s. Too Far in Time	364
6.t. Agency Conflicts	365
6.u. Management Commentary	365
6.v. Watering Information	366
6.w. Reclassifications and Continuous Restatement	366
6.x. Change in Judgment	367
6.y. Entity's Circumstances Are Different	368
6.z. Focus on Consolidated Financial Statements	368
6.aa. Delegation to a Service Organization	369
6.bb. Shooting a Moving Target	369
6.cc. Persistent Behaviors	370
6.dd. Manual Adjustments	371
6.ee. Incorrect Bookkeeping	371
Solutions and Recommendations	371
Conclusion	372
References	373
Index	397

List of Figures

Part II

- Figure 1 Qualitative Characteristics under the IASB (1989) IASB Framework (reframed to compare with the FASB, 1985, CON 2). 12
- Figure 2 Qualitative Characteristics under the Common Conceptual Framework (reframed to compare with the FASB, 1985, CON 2). 13
- Figure 3 Qualitative Characteristics under the IPSAS Framework (reframed to compare with the FASB, 1985, CON 2). 14
- Figure 4 Relevance and Materiality in FASB (1985), CON 2. 17
- Figure 5 Relevance and Materiality in the IASB (1989), IASB Framework. 18
- Figure 6 Relevance and Materiality in Integrated Reporting. 19
- Figure 7 Reliability and Materiality in FASB (1985), CON 2. 22
- Figure 8 Reliability and Materiality in the IASB (1989), IASB Framework. 23
- Figure 9 Relationships between Materiality, Relevance, Completeness, and Reliability in FASB (1985), CON 2. 24

Figure 10	Relationships between Materiality, Relevance, Completeness, and Reliability in the IASB, 1989, IASB Framework.	25
Figure 11	Comparisons of Definitions of Materiality.. . . .	34

Part III

Figure 12	A Positive versus a Negative Concept of Materiality.	83
Figure 13	Graduation of Materiality.	85
Figure 14	Material Information in Users' Decision Process.	87
Figure 15	Multiplying Risk-Level Graphs.	88
Figure 16	Decoupled Effect Risk-Level Graphs..	89
Figure 17	Single Effect Risk-Level Graphs.	89
Figure 18	Recognition versus Disclosure along the Likelihood Axis..	90
Figure 19	The Materiality / Disclosure Dilemma.	94
Figure 20	Possible Dimensions of Materiality.	96
Figure 21	The Flexibility Zone.	97
Figure 22	Eyes of Management versus Eyes of Investors.	98
Figure 23	The Ownership Triangle.	100
Figure 24	Materiality as a Planning Tool.	104
Figure 25	Consensus Materiality.	105

Part IV

Figure 26	IFRS Disaggregation or Aggregation Model for Presentation and Disclosure.	128
Figure 27	Materiality Dimensions for Disclosure..	137
Figure 28	Disclosure Based on Disclosure Relevance.	137

Figure 29	SEC's 1987 Approach to Forward-Looking Disclosure..	146
Figure 30	SEC's 1989 Approach to Known Trends or Uncertainties.	147
Figure 31	Classification of Assertions..	161
Figure 32	Relationship between Audit Risk and Materiality..	163
Figure 33	Examples of Effects of Materiality on Audit Risk. .	164
Figure 34	Interaction of Materiality and Inherent Risk.. . . .	166
Figure 35	Second-guessing Management's Determination of Users' Needs.	167
Figure 36	How Materiality Affects Auditors' Communication.	169
Figure 37	Effects of Materiality on Auditor's Response to Fraud.	170
Figure 38	Effects of Materiality on Auditor's Response to Illegal Acts.	171
Figure 39	Representation of Internal Control Deficiencies in Risk Maps.	174
Figure 40	Relationship between Risk Appetite and Risk Tolerance.	179
Figure 41	Interlock of Risk, Risk Appetite, Risk Tolerance, and Precision of Internal Controls.	179
Figure 42	Risk Tolerance as an Indirect Measure of Materiality.	181
Figure 43	Planned Materiality versus Risk Tolerance and Performance Materiality.	182
Figure 44	Precision of an Internal Control.	182
Figure 45	Inherently Imprecise Controls.	184
Figure 46	Role of Materiality in Testing ICOFR.	186

Part VI

Figure 64 Risk-Level Graph. 312

Figure 65 Significance/Influence Matrix. 316

Part VII

Figure 66 What Standards Say Users Want. 327

Figure 67 References to Materiality Triggering-Specific
Actions. 343

This page intentionally left blank

About the Author

Francesco Bellandi, US CPA (Certified Public Accountant); CGMA (Certified Global Management Accountant); Dottore Commercialista (Italian Chartered Accountant); Diploma in International Financial Reporting from the ACCA (The Association of Chartered Certified Accountants, UK); Degree in Economics (summa cum laude), LUISS University; M.B.A., SDA Bocconi School of Business, Bocconi University; Diploma in Private Equity from the A.I.F.I. (Italy's private equity association).

Francesco Bellandi is a practitioner in US GAAP/IFRSs dual reporting. Named by the AICPA as a worldwide IFRS US GAAP Subject Matter Expert, he is a member of the AICPA, the NYSSCPA (New York State Society of Certified Public Accountants), the NYSSCPA's International Accounting & Auditing Committee where he has chaired the IFRS and the FASB subcommittees. He has been an Editorial Review Board Member of The CPA Journal, New York, USA.

Francesco Bellandi is a forensic auditor. He has served as a board director, chief financial officer, and finance director in several multinational companies around the globe and contract university professor in Audit and in IFRS.

He has authored several publications, including two books published by Wiley & Sons, 2012: *The Handbook to IFRS Transition and to IFRS U.S. GAAP Dual Reporting* and *Dual Reporting for Equity and Other Comprehensive Income under IFRS and U.S. GAAP*.

He can be reached at francesco_bellandi@yahoo.com or francesco.bellandi@dualgaap.com.

This page intentionally left blank

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.

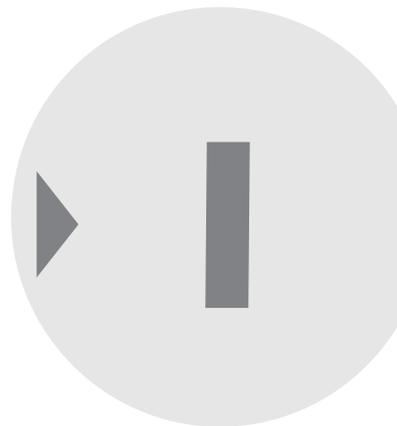
Part VII tackles specific issues of application of materiality. This section includes an illustration of SEC Staff comments on materiality in the review of Form 20-F of foreign private issuers and a checklist of specific accounting pronouncements relating to specific materiality decisions.

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.

This page intentionally left blank

..... Part

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.