ACCOUNTING STANDARDS BOARD

P O Box 7001
Halfway House
Midrand
1685
Tel. 011 697 0660
Fax. 011 697 0666
www.asb.co.za

TO: MEMBERS OF THE BOARD

FROM: JEANINE POGGIOLINI

SUBJECT: REVIEW OF GRAP 3 ON ***ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS***

DATE: 16 SEPTEMBER 2020

FILE REF: Attachment 4(a)

INTRODUCTION

Problem statement

1. The purpose of this project is to respond to questions raised during the public consultation on the Guideline on *The Application of Materiality to Financial Statements* (the Guideline). Respondents asked the Board to provide guidance on whether past decisions about materiality could affect future financial statements. Respondents indicated that, if they had made decisions to depart from the Standards of GRAP based materiality in the past, they were often required by the auditors to:

   (a) keep a historical record of these transactions/decisions;

   (b) assess whether the effect of the transactions/decisions were cumulatively material in subsequent reporting periods; and

   (c) if considered cumulatively material, make retrospective adjustments as if an error was made or a new accounting policy was adopted.

2. Respondents to the draft Guideline indicated that keeping a historical record of the transactions and potentially needing to make retrospective adjustments in future periods, made applying materiality onerous and pointless.

3. At the time of finalising the Guideline, there were differing views about how past decisions about materiality could, or should affect, future periods. These views were as follows:

   - View #1 – Decisions about materiality are period specific and do not affect future periods.

- View #2 – Decisions about materiality should be assessed cumulatively over time to determine if an accounting policy based on Standards of GRAP should be applied to those items. This view would require entities to keep record of past assessments and related transactions and adjust for the effect retrospectively.

4. Due to the differing views, the Board agreed to undertake a separate project to (a) review the requirements in GRAP 3 on *Accounting Policies, Changes in Accounting Estimates and Errors* to assess if it adequately dealt with the issue; and (b) if considered necessary, issue separate guidance.

5. As a result, the purpose of the project is to assess whether:

   - GRAP 3 provides guidance on how to deal with past decisions about materiality, and if not, to propose amendments to GRAP 3 and/or develop additional guidance.
   - Changes are needed to the Guideline.

Decisions to date

6. The Board met in July 2020 and discussed an Issues Paper on the review of GRAP 3. The key decisions were as follows:

   - Decisions about materiality are period specific and would not result in the restatement of prior period information in future reporting periods unless an error occurred in the application of materiality.
   - The application of an accounting policy to items that were considered immaterial in previous reporting periods is not a change in accounting policy.
   - The next steps were to (a) develop an Interpretation of the Standards of GRAP to explain the effect of past materiality decisions, (b) propose an amendment to paragraph .17 of GRAP 3, and (c) review the Guideline to assess if changes are needed.

7. In developing the Interpretation, the Board agreed that the Secretariat should do more work on whether accounting policies based on Standards of GRAP – once adopted – needed to be applied to all similar items going forward, irrespective of their materiality. It was suggested that this could be resolved by considering the "unit of account" for a transaction. It was agreed that the application of materiality and unit of account could be illustrated through examples rather than providing specific guidance.

DEVELOPMENT OF THE INTERPRETATION

8. The Secretariat developed a draft Interpretation on *The Effects of Past Decisions on Materiality* based on the decisions at the last Board meeting. The draft Interpretation is included as attachment 3(b).

9. The project groups (one comprising the firms, auditors, consultants, and technical specialists ("firms"), and one comprising preparers) met in August 2020 to discuss the draft Interpretation.

10. The Technical Committee reviewed the draft Interpretation in September and recommended it to the Board for approval as an Exposure Draft. The key issues deliberated by the Committee are outlined below.

KEY ISSUES DELIBERATED BY THE TECHNICAL COMMITTEE

Issue #1 – Can materiality be applied once a GRAP accounting policy is adopted?

Background to issue

11. At the Board meeting, the Secretariat was asked to re-consider the conclusions reached on the application of accounting policies based on the Standards of GRAP once they had been adopted.

12. The Issues Paper presented to the Board in July indicated that once an entity applies an accounting policy based on Standards of GRAP to similar transactions or classes/categories of transactions, that policy would need to be applied to all similar items or classes/categories of transactions in future periods - irrespective of materiality. This conclusion was reached based on the requirements in paragraphs .12 and .14 of GRAP 3*.* Extracts of the pronouncements referred to in the memorandum are included in an Annexure to this memorandum for ease of reference.

13. The objective of GRAP 3.12 is to establish a principle that once an accounting policy is selected it should be applied consistently from one period to the next to allow comparability over time (see GRAP 3.14). It also explains that when a Standard allows an entity to categorise similar transactions (for example, GRAP 17 allows different accounting policy choices for different classes of PPE; and GRAP 104 requires different accounting policies depending on the classification of financial instruments), then multiple accounting policies will apply to the categories. However, to achieve consistency within the categories, a single accounting policy should be selected and applied consistently to each category.

14. GRAP 3.12 and GRAP 3.14 deal with the consistent application of an accounting policy where accounting policy choices exist for classes or categories of assets in the Standards of GRAP. They do not specifically apply to the application of accounting policies based on materiality.

Conclusion

15. The key objective of the Issues Paper was to solve the initial question about whether past assessments of materiality are errors, or would result in a change in accounting policy, such that retrospective application is needed. As a result, extensive reference was made in the Issues Paper to “past assessments of materiality” and the application of “new accounting policies”. This may have limited the scenarios being considered, i.e. “linear” scenarios where it was assumed that only immaterial transactions existed, and then at a point, those transactions became material and required the adoption of a GRAP accounting policy. This may have led to the conclusion that once a GRAP accounting policy is applied, the same policy should be applied to all items irrespective of materiality.

16. It may be possible for an entity to have items of a similar nature being acquired that could be both material and immaterial in a single reporting period. As GRAP 3.12 and GRAP 3.14 do not deal specifically with the application of accounting policies based on materiality. This means that materiality could be applied once a GRAP accounting policy has been adopted. Therefore, it is possible to apply an “alternative accounting treatment” as well as a “GRAP accounting policy” to similar items depending on materiality. For purposes of the discussion:

- An "alternative accounting treatment" means an accounting treatment that is not based on Standards of GRAP and is applied to immaterial items.
- A "GRAP accounting policy" is an accounting policy based on the Standards of GRAP and is applied to material items.

17. Issue #2 explores how alternative accounting treatments and accounting policies could be applied in more detail.

Issue #2 – How could accounting treatments and accounting policies be applied – "unit of account" or something else?

18. Various scenarios were discussed in the last project groups, Technical Committee and Board meetings that raised questions about the application of materiality and the "unit of account". For example, capitalise all similar items once a GRAP accounting policy is applied, and in another, continue to apply materiality to individual transactions. The examples discussed seemed to highlight that different answers could be reached depending on the level at which transactions are recognised, i.e. individually or as a group.

Exploring the links between "unit of account" and the application of materiality

19. The Secretariat explored whether or how "unit of account" could be used in the application of materiality. In particular, the existing literature in the Standards of GRAP was reviewed. There is limited guidance on the "unit of account" in existing literature, whether in the Standards of GRAP, or internationally at the IASB and IPSASB.

20. The "unit of account" is broadly taken to mean the level at which the recognition and measurement criteria in the Standards are applied to items, i.e. the recognition and measurement criteria can either be applied to an individual item or a group of items. Typical examples include:
    - Recognising immaterial items of property, plant and equipment such as water meters together as a group. This means that one asset is recognised rather than individual items. (See paragraph .09 of GRAP 17 on *Property, Plant and Equipment*)
    - Grouping together items of heritage assets in a collection and measuring the value of the collection.

21. In discussing this issue with the project groups, the Secretariat developed the draft Interpretation linking the application of materiality to the "unit of account". The idea was that how materiality is applied may differ depending on whether items are recognised individually, or whether they are recognised as a group. To illustrate:
    - Scenario #1: An entity acquires desks to use for administrative purposes. An entity accounts for desks individually based on a materiality of R5,000. Desks with a value of less than R5,000 are expensed, and desks worth more than R5,000 are recognised as assets in terms of GRAP 17. This means that entities could have some desks being recognised and some desks being expensed depending on their materiality. This means that it is possible that an entity could have both an alternative accounting treatment and a GRAP accounting policy being applied to similar items in a reporting period.

- Scenario #2: An entity has a significant volume of desks which it uses in its service delivery. Each desk is individually are immaterial, but given the volume are collectively material. It decides to recognise desks as a group. In this instance, an entity would only apply a GRAP accounting policy as all items of a similar nature of material based on how they are recognised.

22. The project groups agreed with the broad outcome of the scenarios, but they did not support the rationale. They did not believe that the application of materiality should be linked to the "unit of account". They noted that there is significant uncertainty about what "unit of account" means, either conceptually or how it should be applied in practice. One of the issues they noted was the derecognition of items once recognised as a "group" as outlined in scenario #2. They believed that linking "unit of account" and materiality may exacerbate the issues in practice.

23. The project group instead proposed to link the application of materiality to an individual and collective assessment of materiality. Under this approach, individual items would still be recognised, but materiality would be applied to decide how those individual items should be accounted for. In deciding whether items are material or not, an entity would need to assess whether both *individual* transactions are material, as well as assess whether individually immaterial items could be material when considered *collectively*.

24. Given the lack of clear principles underpinning the "unit of account", the draft Interpretation has been developed based on an individual and collective assessment of materiality. This approach also links more closely with the existing principles in paragraph 5.26 to 5.28 of the Guideline.

ACTION REQUESTED #1

The Board is requested to CONFIRM whether it supports the view expressed in:

(a) Issue #1 that is possible to apply materiality once a GRAP accounting policy is "adopted", i.e. an entity could apply either a GRAP accounting policy or an alternative accounting treatment to similar items in a reporting period depending on materiality.

(b) Issue #2 that GRAP accounting policies and alternative accounting treatments should be applied based on an individual and collective assessment of materiality.

Issue #3 – Transitional provisions

25. Given the diversity in practice historically, project group members suggested developing transitional provisions for the initial adoption of the draft Interpretation. The Technical Committee debated whether the transitional provisions should require retrospective or prospective application.

26. The draft Interpretation provides guidance on the circumstances when past assessments about materiality could result in an error and retrospective adjustments to prior period information. While some of the circumstances may be easy to identify, e.g. omissions or the intentional misrepresentation of information, others may require a high degree of judgement, e.g. whether all information available in previous reporting periods was used appropriately.

27. The majority of the Technical Committee members agreed that the draft Interpretation should be applied prospectively. This means that the principles would be applied on a go forward basis and that entities should not go back and adjust for any past decisions about materiality, including if an error was made. This would avoid entities applying hindsight and simplify the initial application.

ACTION REQUESTED #2
The Board is requested to CONFIRM the proposed transitional provisions in paragraph .16 of the draft Interpretation.

Issue #4 – Consequential amendments to other pronouncements

28. The Board agreed that an amendment is required to GRAP 3.17(b). This is outlined in Annexure B to the draft Interpretation.

29. The Secretariat was asked to review the Guideline to ensure it is consistent with the proposals in the draft Interpretation. The relevant paragraphs from the Guideline are paragraphs 5.26 to 5.28 and paragraphs 6.5 to 6.6. Based on the review, no amendments are deemed necessary to the Guideline.

ACTION REQUESTED #3
The Board is requested to CONFIRM the amendments to GRAP 3, and that no changes are needed to the Guideline.

Issue #5 – Review of the draft Interpretation

30. The draft Interpretation has four parts:

- Main body of the Interpretation – outlines key principles.
- Application guidance – provides further explanations on the principles and discusses examples.
- Consequential amendments – proposed amendments to GRAP 3.
- Basis for conclusions – outlines the Board's key considerations in formulating the principles in the main body of the Interpretation.

ACTION REQUESTED #4
The Board is requested to REVIEW the draft Interpretation, and if considered appropriate, APPROVE it for issue as an Exposure Draft

Issue #6 – Way forward

31. The Invitation to Comment (ITC) is included as attachment 3(c).

32. No specific matters for comment were identified for inclusion in the ITC.

33. The usual comment period is 3 months, but given the current environment[1], it was agreed that it may be appropriate to extend the comment deadline into 2021. The project groups suggested a comment deadline of end February 2021.

[1] The deadline for the comment on the Exposure Draft on *Employee Benefits* is due end November. The submission of municipal financial statements has been extended to 31 October.

ACTION REQUESTED #5

The Board requested to INDICATE if it agrees:

(a) that no specific matters for comment are needed.

(b) with the comment deadline.

ANNEXURE – EXTRACTS FROM PRONOUNCEMENTS (FOR INFORMATION ONLY)

Pronouncement	Extract
GRAP 3	*12. An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard of GRAP specifically requires or permits categorisation of items for which different accounting policies may be appropriate. If a Standard requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.*
	.14 Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in an accounting policy meets one of the criteria in paragraph .13.
GRAP 17	*.09 This Standard does not prescribe the unit of measure for recognition, i.e. what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as library books, computer peripherals and small items of equipment, and to apply the criteria to the aggregate value.*
Conceptual Framework for General Purpose Financial Reporting	*6.10 The unit of account is the group of rights, the group of obligations or the group of rights and obligations, to which recognition and measurement requirements are applied.* *6.11 A unit of account is selected for an asset or a liability after considering how recognition and measurement will apply, not only to that asset or liability, but also to the related revenue and expenses. The selected unit of account may need to be aggregated or disaggregated for display or disclosure purposes.* *6.12 In some circumstances, it may be appropriate to select one unit of account for recognition and a different unit of account for measurement (for example, contracts may sometimes be recognised individually but measured as part of a portfolio of contracts).*
Guideline on The Application of Materiality to Financial Statements	*5.26 Assessing whether information is material or immaterial should be undertaken both on an individual and collective basis.* *5.27 In deciding whether an item should be assessed individually or collectively, entities consider the nature of the item, size of the item, or both.* 5.28 *Information can be considered to be immaterial individually however it might be material when considered together with other information. If an entity concludes that aggregation is appropriate, it should consider the nature of the items in deciding what to aggregate together. Aggregations can also be assessed at different levels, e.g. for a class of transactions, for line items in the financial statements, or for a sub-total/total presented.*
	6.5 An entity should review its accounting policies on an on-going basis to assess whether they are still appropriate for its current operations, and to ensure that material items are accounted for in accordance with the Standards of GRAP. *6.6 When an entity has developed a particular accounting policy, without following the specific requirements in the Standards of GRAP as outlined in paragraph 6.4, it needs to be aware of the materiality of the individual or aggregate transactions and the <u>cumulative effect</u> that the policy may have on the statement of financial position, statement of changes in net assets and notes to the financial statements. Consequently, an entity does not only assess the impact of the individual or aggregate transactions but considers the potential <u>accumulation of those transactions in the line items affected in the financial statements for the current or future periods</u>. The*

	assessment is made with reference to the entity's materiality considerations and thresholds set for the individual classes of transactions, account balances, disclosures and/or the financial statements as a whole (see paragraphs 5.5 to 5.7). In assessing whether the effect of applying accounting policies is immaterial, an entity takes into account both qualitative and quantitative factors in its assessment (see paragraphs 5.20 to 5.25). [own emphasis added]