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Submission via website

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Dear Ross

COMMENT ON THE PROPOSED IPSAS PRACTICE STATEMENT ON *MAKING MATERIALITY JUDGMENTS* (ED 97)

We thank you for the opportunity to comment on ED 97.

The views in this comment letter are those of the Secretariat of the ASB and not the Board. The comments were formulated after consultation with our stakeholders, which included preparers, auditors, technical experts, consultants and users.

Locally, our Board issued non-mandatory guidance on materiality in the Guideline on *The Application of Materiality to Financial Statements,* which explains how to apply the concept of materiality when preparing financial statements in accordance with local Standards. Our stakeholders have experience with applying materiality and using this local Guideline.

In general, we support the development of non-mandatory guidance to assist public sector entities in making materiality judgements, and for this guidance to be based on the IFRS® Practice Statement 2: *Making Materiality Judgements*, adapted for the public sector.

Our stakeholders support the alternative view that the proposed guidance is not sufficiently adapted for the public sector. In their view, the guidance remains too private sector focused and does not adequately reflect the public sector decision-making and accountability needs of the broader public sector primary user group.

We also recommend that parts of the guidance currently included in the proposed Practice Statement be published as separate guidance (refer to our comment in Annexure B).

This letter includes:

- Annexure A: Responses to the Specific Matters for Comment
- Annexure B: Comments on other areas
- Annexure C: Editorial changes

Should you have any questions regarding the comments outlined in this letter, please feel free to contact me.

Yours sincerely

Elizna van der Westhuizen

Head of Technical

ANNEXURE A – RESPONSES TO THE SPECIFIC MATTERS FOR COMMENT

Specific Matter for Comment 1:

The IPSASB decided to issue non-mandatory guidance in making materiality judgments when preparing financial statements aligned with Practice Statement 2 (see paragraphs BC10–BC22). Do you agree with how the IPSASB adapted Practice Statement 2 guidance for the public sector context? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

The ED includes an Alternative View that the non-mandatory guidance in [draft] IPSAS Practice Statement, Making Materiality Judgments, could benefit from further public-sector adaptation.

We support the development of non-mandatory guidance that is aligned with the IFRS Practice Statement, *Making Materiality Judgments* to help entities make materiality judgements when preparing financial statements. However, we do not agree that the proposed guidance has been sufficiently adapted for the public sector and therefore support the Alternative View.

Our reasons for supporting the Alternative View are outlined below.

1. Addressing users' accountability needs

The proposed Practice Statement explains that the objective of public sector financial statements is to provide information about an entity that is useful to primary users for accountability and decision-making purposes. Assessing materiality involves considering both these aspects, i.e. accountability and decision-making.

We support the alternative view that, because the user base in the public sector is broader compared to the private sector, the discussion on the information needed by primary users, i.e. resource providers and service recipients, should be considered in the context of their broader accountability and decision-making needs throughout the guidance. For example:

- Paragraphs 9 and 10: The guidance in these paragraphs explains that an entity identifies information that primary users may need to understand transactions, events and conditions. The discussion focuses mainly on information needed to understand the effect on an entity's financial position, financial performance and cash flows. The guidance can be expanded to discuss a broader public sector perspective; for example, information that helps users assess whether resources were raised and used in line with the approved budget, and whether assets needed for service delivery are properly maintained.
- Paragraphs 42 to 45: These paragraphs explain that an entity assesses whether information could influence accountability or users' decisions. The guidance can be expanded to explain how the accountability assessment may be performed from a public sector perspective. For example, the guidance can explain that resource providers may need information to assess whether the entity utilised the funds economically, efficiently and effectively, as intended per agreement, budget or other mechanisms. Service recipients may need information to assess whether the entity spent funds (e.g. taxes) as intended, and protected or enhanced its capacity to provide services in future.

- Some examples, such as examples E, and G do not illustrate how users' accountability needs are assessed when making materiality judgements and only focus on the information needed by users for decision-making. These examples could be expanded to illustrate the importance of evaluating both accountability and decision-making needs of users.

2. Guidance on public sector-specific IPSAS

We support the alternative view that the proposed guidance should better explain how materiality judgements apply to public sector-specific IPSAS Standards. Examples include assessing materiality in relation to the following:

- The budget variances and related explanations when applying IPSAS 24 on *Presentation of Budget Information in Financial Statements* are central to users' assessments and critical to the accountability cycle. Entities often do not understand how to assess materiality in the context of IPSAS 24 and apply the same materiality throughout the financial statements. Guidance and illustrative examples on how materiality should be assessed in relation to budget variances will be helpful.
- The application of materiality to Standards unique to the public sector, for example IPSAS 47 on *Revenue* and IPSAS 48 on *Transfer Expenses*. Guidance on applying materiality for revenue and transfer expense transactions, especially those transactions unique to the public sector, that fall within the scope of IPSAS 47 and IPSAS 48 will be useful.
- Constraints and other obligations. The alternative view (see AV6(a)) noted that covenants are less prevalent for public sector entities. Our stakeholders confirmed the view that, even though covenants may exist in the public sector, they are uncommon and other types of constraints and obligations, such as conditions or restrictions attached to grants and transfers, or the use of appropriations, are more prevalent. We recommend replacing the guidance and example on covenants with more common public sector-specific scenarios that have similar consequences as covenants. This recommendation is in addition to our recommendation on the placement of the guidance (refer to our comment on this in Annexure B).

3. Interaction of qualitative and quantitative considerations

Materiality judgements should involve both quantitative and qualitative considerations. In the public sector, qualitative considerations are often more important because entities receive and use public resources, for which they are accountable. Therefore qualitative considerations are often more important from an accountability perspective, which is unique to the public sector. Public sector entities also operate within a robust legal and regulated environment that places more emphasis on the inherent characteristics and consequences of transactions or events, thereby necessitating qualitative consideration.

We therefore support the alternative view that more guidance is needed to explain how public sector entities can identify and apply qualitative factors. This guidance can include indicators and examples of characteristics that make an item material based on its nature. For example:

- Sensitivity, frequency and potential consequences of the item. Examples include (a) the degree of estimation or judgement that is needed to determine the value of an item, e.g. a high degree of estimation may be involved to measure a complex financial instrument transaction such as a financial instrument, or whether or not an arrangement is a binding arrangement; (b) the frequency with which an item occurs, e.g. a once off transfer of funds from one entity in terms of a legislative directive to "bail out" another public sector entity; or (c) the underspending of a budget that results in service delivery delays.

- The unusual nature of a transaction or event that gives rise to the item. An example is events that occur after the reporting date, e.g. the discovery of fraud after the reporting date.

Based on the above, we also question the proposal in paragraph 55 *"that assessing an item of information from a quantitative perspective first could be an efficient approach to assessing materiality."* This is because, in our view more emphasis should be placed on the qualitative characteristics of a transaction or event in the public sector and therefore do not believe a quantitative-first approach would necessarily be efficient in practice. We therefore recommend that the statement in paragraph 55 be removed or altered.

We also disagree with the principle in paragraph 56 *"… in some cases an entity might decide that, despite the presence of qualitative factors, an item of information is not material because its effect on the financial statements is so small that it could not reasonably be expected to influence the discharge of accountability by the entity, or decisions made by its primary users."* This principle is also illustrated in Example L – *Information About a Related Party Transaction Assessed as Immaterial* where it is concluded that the transaction is immaterial despite the presence of qualitative factors. Making materiality judgements involves an assessment of both the quantitative and qualitative characteristics, which are separate assessments.

- The quantitative assessment considers whether the size of an item affects either the users' assessment of accountability or making decisions.
- The qualitative assessment considers whether the nature of an item (its inherent characteristics or the circumstances in which the item was undertaken) is such that it affects either the users' assessment of accountability or making decisions.

If a qualitative aspect makes an item material, but not a quantitative aspect, it is inappropriate to conclude that the transaction or event is immaterial because of the size. We recommend that the guidance in paragraph 56 and the related Example L be amended.

We also found the logic in *Example K – Information about a related party transaction assessed as material* difficult to follow. Similar to Example L, the example initially concludes that the impact of the related party transaction is immaterial from a purely quantitative perspective. It is then concluded that the transaction is material from a qualitative perspective. In the last paragraph, the example again considers materiality from a quantitative perspective. As noted above, making materiality judgements involves an assessment of both the quantitative and qualitative characteristics, which are separate assessments. Although we appreciate the one assessment may impact the other, if either indicates an item affects the users' assessment of accountability or making decisions, the item is material.

We recommend that the logic/flow of the assessment in Example K be reconsidered.

Specific Matter for Comment 2:

Do you find the examples on applying the concept of materiality when preparing financial statements in accordance with IPSAS Standards helpful? Do you think any additional practical examples should be included? If so, what scenarios should the examples address? Please be as specific as possible and explain why those examples would be helpful to entities.

Even though we find the examples useful, we are of the view that additional examples should be included to illustrate public sector-specific IPSAS Standards.

We support the alternative view for the proposed Practice Statement to include additional examples to better explain the application of making materiality judgements to public sector-specific IPSAS Standards as outlined in our response to Specific Matter for Comment 1 item 2.

We further recommend that additional examples be included to explain the application of materiality to the recognition and measurement of items. The examples currently included in the Practice Statement mostly deal with the application of materiality to presentation and disclosure of items. A common example that can be illustrated is the treatment of servitudes that are capitalised to the cost of the associated asset (i.e. land) rather than to classify it as an intangible asset.

ANNEXURE B – COMMENTS ON OTHER AREAS

Scope of the Practice Statement

We question the scope of the proposed Practice Statement in paragraph 3, which indicates that the Practice Statement does not apply to the Cash Basis IPSAS Accounting Standard. In our view, as the proposed guidance is non-mandatory, it can be considered when applying the presentation and disclosure requirements in the Cash Basis IPSAS Accounting Standard. Paragraph BC7 in the basis for conclusions does not sufficiently explain the IPSASB's rationale for not including the Cash Basis IPSAS Accounting Standard.

Application guidance outside this Practice Statement

In addition to our recommendation in Specific Matter for Comment 1 item 2 to reconsider the guidance on "information about covenants", we recommend that the inclusion of the last part of the proposed Practice Statement on "specific topics" be reconsidered. Given its practical nature, we are of the view that the guidance may be more appropriate in a separate document, such as "IPSASB Explains" or a "Question and Answer" publication that addresses the application of materiality to specific topics. Presenting practical examples in a separate publication will provide greater flexibility to respond to additional topics or implementation questions on materiality that may arise in the future.

Materiality considerations by preparers and auditors

Stakeholders noted that making materiality judgements when preparing general purpose financial statements differs from the auditors' assessment of materiality when they audit those financial statements. With reference to the recommendation above that guidance on specific topics be developed outside this Practice Statement, we propose that the difference in applying materiality from a preparer's and auditor's perspective be acknowledged and considered when such guidance is developed.

Example B – Materiality Judgements on the Application of Accounting Policies

Consider expanding the application part in the example by including an additional bullet point for "affects … the cost of the asset where borrowing costs are capitalised".

ANNEXURE C – EDITORIAL CHANGES

Paragraph reference	Amendment proposed
Example A – Materiality Judgments on the Application of Accounting Policies	Application …., because information reflecting the capitalization and <u>**depreciation**</u> ~~amortization~~ of such expenditure
Example L - Information About a Related Party Transaction Assessed as Immaterial	Application As in Example **K** ~~L~~, the entity
Discharge of Accountability by the Entity and Decisions Made by primary users Paragraph 21	…as whether the entity: (c) Is unlikely to need additional (or **fewer** ~~less~~) resources…
Basis for conclusions BC7	…applicable to the Cash Basis IPSAS Accounting Standard~~s~~