CIPFA/LASAAC

The 2020/21 Code of Practice on Local Authority Accounting in the United Kingdom

Appendix A to the Invitation To Comment:

Materiality and Disclosures

Purpose

This appendix was provided to CIPFA/LASAAC as a basis for consideration and discussion of potential Code amendments to support CIPFA/LASAAC's vision statement achievement to materiality and disclosure judgements.

1 Content of Paper

1.1 This paper includes sections on:

- Materiality
- Disclosures
- Code development

1.2 To assist with focus this paper does not seek to cite large elements of relevant references. Summarised notes and overviews are included where it is considered helpful. Appendix 1 includes a list of relevant references for materiality, Appendix 2 for disclosures.

1.3 The key objective is to identify what potential options CIPFA/LASAAC could consider in developing future Code requirements.

2 Materiality

2.1 Based on IFRS, the Code 19/20 para 2.1.2.14 states (spacing added):

> "**Materiality** – information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting authority.
>
> In other words, materiality is an authority-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual authority's financial statements.
>
> Consequently, the Code cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.
>
> Materiality is an important concept for preparers of financial statements because, although decisions on the type of information which is useful are generally made by standard setters, judgements on whether matters are material are necessarily a matter for preparers.
>
> An authority can comply with the Code, while not complying with specific disclosure and accounting requirements in the Code, if the information is not material to the 'true and fair' view of the financial position, financial performance and cash flows of the authority and to the understanding of users."

2.2 Application of materiality will also normally be considered in the context of the provision of a 'true and fair view'; and the fundamental qualitative information characteristics of relevance and faithful information (complete, neutral and free from error) [2.1.2.10 onwards].

2.3 Of the enhancing characteristics of information understandability may be particularly relevant as it specifically refers to classification decisions (eg aggregation) [2.1.2.22]

IFRS: Amendments to Definition of Material

2.4 The IASB has issued 'Definition of Material: Amendments to IAS 1 and IAS 8' (October 2018). The amendments are effective from 1/1/20, although early adoption is permitted.

2.5 The amendments include the following (bold added for emphasis):

a) "Information is material if omitting, misstating or obscuring it **could reasonably be expected** to influence decisions.."

b) Example of obscuring information: "information regarding a material item, transaction or other event **is scattered throughout the financial statements**;"

c) Example of obscuring information: "the understandability of the financial statements is reduced as a result of **material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material**."

d) Recognition of the different needs of different readers: "Many existing and potential investors, lenders and other creditors **cannot require reporting entities to provide information directly to them** and must rely on general purpose financial statements for much of the financial information they need. **Consequently, they are the primary users to whom general purpose financial statements are directed."**

2.6 Reference to BC 13D and BC13H may also be relevant.

Aspects affecting vision statement achievement

2.7 The following are suggested as key aspects affecting the achievement of CIPFA/LASAAC's vision:

a) Materiality judgements should support and enhance the clarity of the accounts for readers, and help them to access information and support decision making.

b) Materiality application is dependent on factors specific to each authority

c) Judgements, by authorities and auditors, are therefore required

d) Based on existing authority accounts it appears that different authorities and/or auditors may reach different views regarding materiality application

e) To make materiality judgements both authorities and auditors require evidence

f) The cost of the evidence base will include cost of collation, analysis and verification.

g) For both authorities and auditors there are risks, both financial and reputational, in making materiality judgements, for instance arising from regulator or court actions at a later date if accounting information is challenged.

h) Alignment, where possible, and mutual understanding of authority and auditor materiality application would be beneficial.

i) Documenting and explaining decisions regarding materiality application can be considered desirable.

j) A number of factors, including cost and risk, will affect behaviours regarding materiality judgements.

Potential considerations affecting Code proposals

2.8 From the above the development of Code proposals may be influenced by consideration of:

a) The need for judgements to improve the accounts for readers

b) The need for the Code to allow and support application of judgement by authorities and auditors

c) The potential for the Code to support more consistency regarding the application of judgement

d) The limitations of the Code in respect of specifying the sufficiency of the evidence base which is appropriate to inform authority and auditor judgements

e) The extent to which the Code can support an outline risk management framework to assist authorities and auditors in making materiality judgements

f) The behaviours that any proposals may support or encourage

g) The impact that any proposals may have on stakeholders, including the users of local government annual accounts

Specific aspects regarding materiality

2.9 The following table is intended to provide a brief overview of, and framework for, the discussion of materiality application. Some example references (see the Appendices for full titles) are provided.

	Item	Evidence Requirements	Risk Aspects
A	Readers	Evidence or assumptions regarding the readership, their needs and decisions. This includes regulatory bodies. See IAS 320 para 4	Risk that there is a potential lack of information regarding readers and their decisions
B	Qualitative and Quantitative	Evidence to inform judgements in respect of qualitative and quantitative importance for non-statutory disclosures.	A risk is that judgement may be based predominantly on one aspect, not on both.
C	Statutory disclosure requirements	Knowledge of the statutory requirements.	Risks that statutory requirements may not be complied with.
D	Information characteristics	Confirmation that the evidence supports the fundamental characteristics of relevance and faithful information (complete, neutral and free from error). Understandability may also be assessed.	Risk that relevance and faithful representation may not be appropriately assessed or evidenced.
E	Internal Controls / Governance	Evidence of sound internal controls may affect auditor determination of materiality limits in some circumstances. (see ICAEW Materiality paper page 9).	Indications of ineffective internal controls will affect the assessment of risk and therefore the evidence base required. (see performance materiality)

	Item	Evidence Requirements	Risk Aspects
F	Overall materiality	Determination of a key benchmark on which the overall materiality judgement is made (usually as a %). Note – IAS 320 A3 relates to the public sector noting that regulatory, legal, public interest and other factors will be relevant. Para 10 includes (emphasis added):"When establishing the overall audit strategy, the **auditor shall determine materiality for the financial statements as a whole**."	Risk that an inappropriate benchmark is selected. Risk that a single benchmark is not suitable for all aspects (eg HRA tenants may only be interested in the HRA I&E statement, affecting their materiality needs). See H below. Risk that the benchmark % is too high or too low. (See FRC thematic review for extent of private sector variation)
G	Appropriate benchmark for overall materiality	Generally the benchmark (used in F above) will be a specific item in the accounts See IAS 320 A10 re public sector specific benchmarks eg total cost or net cost (focus on spend) or assets (where entity has custody of public assets)	Risk that the nature of local government accounts, and particularly the use of the revaluation model for some PP&E assets, results in an inappropriate benchmark.
H	Particular materiality levels for specific items	IAS 320 para 10 requires that specific materiality levels are set for particular items where appropriate. HRA may be an example. (see also A11-12). NB IAS 320 para 9 includes these thresholds as performance materiality items.	Risk that either too few or too many 'particular materiality' levels are set.
I	Performance materiality	IAS 320 paras 9-11 & A13 require that, to allow for the impact of aggregated misstatements, a margin for uncorrected and/or undetected misstatements is allowed. Involves auditor judgement based on risk and circumstances.	Potential that the 'margin' allowed for is either overly risk tolerant or too risk averse.

	Item	Evidence Requirements	Risk Aspects
J	Accounts preparation materiality	It would normally be anticipated that the authority and the auditor agree in advance the materiality levels for the accounts. There is no clear requirement to do so.	Failure to agree initial expected materiality level(s) risks either (a) excessive accounts preparation work being undertaken by the authority or (b) additional work being required during the audit process to evidence materiality Note that ISA 320 requires that the auditor may need to revise their materiality levels during the audit. This may be affected by the cumulative impact of immaterial adjustments in the reporting period.
K	Cumulative (prior period) Errors	The IFRS Practice Statement (paras 77-80) notes that uncorrected errors may accumulate over time (eg over a number of years, for instance in respect of depreciation calculations). Where these cumulative errors are regarded as material to the current period (change in circumstances or further accumulation) correction of cumulative errors is expected.	Excessive risk tolerance in individual years may lead to a requirement, in a later year, for significant adjustments. This may particularly be the case where a change in auditors specifically involves a re-examination and re-assessment of uncorrected errors.
L	Disclosure of materiality assessment and judgements	There is no apparent specific requirement to provide detailed disclosures in the accounts regarding materiality assessment or thresholds. See Accounting for Democracy (HoC PACAC) para 138 "Materiality for Government Accounts should be disclosed…", "in the private sector where materiality is already disclosed." "Materiality helps people understand how detailed the audit of the Accounts has been and how far they should rely upon the auditor's assessment about the accuracy of the figures."	A risk exists that readers of the accounts are not fully aware of the materiality applied, and thus may misinterpret information when making decisions.
M	Group accounts (component materiality)	Materiality threshold(s) for group accounts need to be established and normally aligned across members of the group. See ICAEW Materiality paper Chapter 5	A risk arises that group accounts materiality assessment judgements are not appropriately aligned.

	Item	Evidence Requirements	Risk Aspects
N	Prior period comparatives	The IFRS Practice Statement (paras 70-71) supports explicit consideration of prior period comparative materiality. It allows that prior period information may be summarised, if that does not affect an understanding of the current period statements.	This reduces the risk of excessive unnecessary detail eg provision of detailed prior year information tables. Academics and others may however prefer the convenience of having a full two year data set in one document.
O	Complex Transactions	Complex transactions or those with particularly significant implications, such as risk exposure, may require particular materiality consideration in respect of reader's needs.	A risk arises that complex or particularly significant transactions are not appropriately disclosed. For example non-disclosure, or a disclosure not being appropriately presented (hidden in detail, not recognised as a 'key message').

3 Disclosures

Aspects affecting vision statement achievement

3.1 Feedback and comments from stakeholders indicates that some concerns regarding existing disclosure practices are:

a) Excessive disclosures being made, which dilute the focus of the accounts and obscure important information for readers

b) Disclosures for material items are not clearly highlighted and do not appropriately provide readers with a clear explanation, in both qualitative and quantitative terms, of the significance of that item for readers

c) Whether sufficient and/or appropriate evidence is available to support an assessment of the materiality of a particular disclosure for readers

d) The resource requirements involved in assessing whether a specific disclosure is material for readers

Relevant references

3.2 The following extracts from relevant papers (see also Appendix B) may be considered helpful:

Source	Extract
Accounting for Democracy (House of Commons, PACAC, 2017) Para 128	Regarding a need to ensure that disclosures are suitable for readers of public sector accounts: "it is important that although the accounts currently meet the international standards, the Government makes additional disclosures ….. above and beyond standard corporate accounting."

Source	Extract
The Government Financial Reporting Review (HM Treasury, 2019) Para 3.22-3.23 (emphasis added)	"When considering whether to add new disclosures to the annual report and accounts, **preparers should consider the following questions**: Should the information be published? • Is the information required by statute? • **Is there a user need, and who is the user?** • Is the information accurate and reliable? • **Do the benefits of disclosure outweigh the costs and give value for money?** How should the information be published? • Is this report the right place for it? • **Is this information already available elsewhere, or could it be?** • How will the new disclosure affect the overall balance of the report?" "**The Treasury will use these questions to inform future reporting guidance**, and **will include them in the revised Financial Reporting Manual** for those preparing government financial reports to refer to."`
The Government Financial Reporting Review (HM Treasury, 2019) Para 5.35 (emphasis added)	In relation to building trust in public financial reporting it states "Another aspect of transparency is risk disclosure." and indicates information should cover: • "identification of risks • management of risks • how those risks have changed through the period • the impact of those changes and management's response" Para 6.24 notes "There are several ways that strategic risks are reported. Many departments refer to risk throughout their annual reports and accounts, while others have a separate section in the performance report."

Source	Extract
EFRAG/ANC/ FRC - Towards a Disclosure Framework for the Notes- Discussion paper (2012) (extracts from paras 1-14) Emphasis added	"disclosures in the notes should provide **information which amplifies and explains** the primary financial statements;" "notes should provide information such as, but not limited to, (a) **assumptions and judgments** that are built into the reported numbers of items in the balance sheet and profit and loss; (b) **information on risks that may affect these reported numbers**; and (c) **alternative measurements** where this information would be **relevant**" "the **more uncertainty** affects the amounts in the primary statements, **the more disclosures are usually needed.**" "Disclosure requirements should be **principle-based** and detailed rules should be avoided" "Disclosure requirements should **achieve proportionality to the entity's users' needs**, and meet a **reasonable cost-benefit trade-off in all circumstances**. **Alternative disclosure regimes may have to be put in place to achieve proportionality**."
FRC ISA 540 (UK) Auditing Accounting Estimates and Related Disclosures Para 11	"The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial **statements are reasonable in the context of the applicable financial reporting framework.**" (emphasis added)

Potential considerations affecting Code proposals

3.3 Potentially adoption of HM Treasury's proposed disclosure questions (see above) will be considered appropriate, and support alignment of public sector financial reporting.

3.4 Additionally, to reflect the anticipated interests of the key readers of public sector accounts, focus may also be placed on ensuring that disclosures, for an item, explain and illustrate to non-accountants:

a) the significance of the item to the entity and thus to public sector resources

b) the stewardship decisions taken in the year

c) the significant (material) risks arising

d) the risk management arrangements in place (where material risks are identified)

3.5 Furthermore it may be noted that

a) more recent IFRS standards have sought to specify the purpose of disclosures, prompting preparers and auditors to critically assess whether those purposes, in the context of reader needs, are being achieved

b) the Government Financial Reporting Review (Chapter 5) emphasises the need for building trust in annual reports and accounts

c) Disclosures could reasonably be anticipated in relation to financial management items that are significant for governance. For example a financial risk that is significant for governance would normally be expected to be material for readers interested in the authority's accountability for taxpayer resources.

4 Code Development

Potential Code development options

4.1 The following potential actions in the Code are identified as an initial basis, subject to CIPFA/LASAAC consideration, for development of consultation proposals.

	Option	Risk Management Implications	Potential Behaviours
1.	Specification in the Code of the anticipated main users of statements, and potentially their needs, subject to rebuttal based on specific factors for an authority	To support more consistency of local judgement and a focus on identified needs of users. Potential risk of inappropriate 'boilerplate' implementation.	More explicit judgement regarding the needs of users. Improved specification of the evidence required to support material assessments for identified user needs.
2.	Clear identification of statutory disclosure requirements	To ensure statutory requirements are explicit	Compliance with legislation
3.	Provision in the Code of a list of potential key material data items for main benchmark and particular materiality levels. No indication or guidance proposed on which would be relevant to an authority.	Support consistency. Potentially significant risk of conflict or overlap with ISA and audit requirements. Potentially more suitable for non-Code guidance (eg CIPFA publication or audit community collaboration).	Key reference to the list of data items for use, dependent on local judgement, by authorities and auditors in setting materiality levels.
4.	Disclosure in the accounts of the materiality levels applied by the authority.	Mitigate the risk of reader misinterpretation of annual accounts information. May mitigate the potential for later regulator actions if materiality has been transparently disclosed. An additional disclosure in the annual accounts may be negatively perceived, unless it clearly achieves the vision statement and supports a reduction in cost and risk.	Increased transparency and co-ordination between all authorities and auditors regarding materiality levels.

	Option	Risk Management Implications	Potential Behaviours
5.	For disclosures specified in the Code provide an indication of expectations eg the Code may specify for in each Chapter/ Section: • That some disclosures are normally expected to be commonly material (ie they should be regarded as material unless proved immaterial); • That some disclosures are not expected to be commonly material (ie they are immaterial unless evidence indicates disclosure is material).	Increase consistency in judgement regarding which disclosures are most commonly anticipated to be material, while allowing scope for local rebuttal. This may not fully mitigate the 'evidence burden' for both authorities and auditors if detailed evidence for ALL notes is expected to be provided and reviewed.	Improved authority and auditor agreement and understanding regarding the importance of a specific disclosure.
6.	For disclosures in the Code list only those which are commonly expected (material unless proved immaterial) and simply cross reference to the standards for those which are exceptional (immaterial unless proved otherwise)	Increase consistency regarding which disclosures are expected. Risk however that some relevant disclosures may be omitted if the standards are not reviewed by the authority and auditor. Potentially this risk may be mitigated by non-Code Guidance.	Improved authority and auditor agreement and understanding regarding the importance of a specific disclosure.
7.	For specific information requirements and disclosures in the Code apply a 'must', 'should' and 'may' approach to indicate the extent to which an information item is mandatory, expected or entirely at local discretion.	Increase consistency regarding which disclosures are expected. A risk arises that some annual accounts will provide the absolute minimum requirements, without a wider consideration of the needs of their specific readers.	Improved authority and auditor agreement and understanding regarding the importance of a specific disclosure.

	Option	Risk Management Implications	Potential Behaviours
8.	Explicit statement in Code that prior period comparative information may be summarised, if that does not affect an understanding of the current period statements.	Enhance focus and clarity of accounts for readers regarding current year financial position and performance. Possible loss of full two year data sets in a single document.	Reduction in provision of non-relevant information.
9.	Inclusion of HM Treasury / FReM disclosure questions to ensure appropriateness of disclosures	Enhance focus and relevance of disclosures for identified interests of readers. Requirement to manage and mitigate risk of later criticism of judgements applied, including reader needs and cost-benefit assessment. Excessive emphasis on 'cost benefit' assessment may mean appropriate disclosures are not made. Risk avoidance may result in excessive disclosures being made.	Improved focus in accounts. Improved emphasis on user needs required in order to inform application of the HMT criteria.
10.	Increased explanation in Code of the purpose of disclosures, and potentially of default assumptions regarding user needs, to inform and support preparer and auditor assessment of application judgements.	Improvement in consistency of judgements and focus on key reader needs. Risk that in some cases (eg entities with significant commercial and/or group interests) the needs of other reader groups (eg commercial partners, lenders, unions etc) are not adequately assessed i.e. that any default assumptions are not properly tested and refuted ('boilerplate' approach is adopted).	Non-core readers (eg commercial partners etc) may require and request specific information from other sources (eg direct request to the entity). Such data may not be subject to audit and may reduce confidence in decision making.

	Option	Risk Management Implications	Potential Behaviours
11.	More frequent adaptation or interpretation of disclosure requirements for local government, with explicit identification in Code of these	More specification may reduce the risk that disclosures are seen as 'irrelevant'. Potentially less comparability with other sectors / other public sector bodies. Potentially more uncertainty regarding requirements, more reliance on judgement and less overall consistency in preparer and auditor application of requirements. Risk that this may lead to omission of key disclosure information (eg in relation to uncommon transactions). Ie a 'blanket assumption' regarding disclosures for local government as a whole may be inappropriate.	More specific focus by preparers and auditors on local government specific requirements. Improved decision making by accounts readers.

Appendix 1 – Materiality - Relevant References

	Title	Section / Comment
A.	Code 19/20	
B.	IFRS: Conceptual Framework for Financial Reporting	Esp. para QC11
C.	IFRS Practice Statement 2: Making Materiality Judgements	Non-binding key reference, with a focus on private sector application.
D.	IFRS Materiality Judgements: Project Summary and feedback Statement	Useful summary and outline of materiality application process for private sector. See also this IFAC article
E.	IFRS Materiality Practice Statement: resources webpage	
F.	FRC: Audit Quality Thematic Review Materiality	Helpful reference, including specific details and comparison of audit firm approaches to materiality judgements (mainly private sector).
G.	FRC: ISA (UK) 320 Materiality in Planning and Performing an Audit	Core requirement for auditors
H.	FRC: ISA (UK) 450 Evaluation of Misstatements Identified During the Audit	Core requirement for auditors
I	FRC: ISA (UK) 720 The Auditor's Responsibilities Relating to Other Information	Core requirement. See also FRC staff guidance note 03/2017.
J	CIPFA: Streamlining the Accounts: Guidance for Local Authorities pre-publication draft	Section Two on Materiality, example application of thresholds in Appendix A
K	ICAEW Materiality in the audit of financial statements	Comprehensive reference with examples
L	ICAS A Professional Judgement Framework For Financial Reporting Decision Making	Wider than just materiality. Notably page 27 details specific recommendations for standard setters.
M	ICAS Webpage –overall vs performance materiality	
N	ICAS webpage – materiality thresholds	

	Title	Section / Comment
O	IPSASB Staff Questions and Answers on Materiality	IPSAS (public sector standards) specific commentary and advice.

Appendix 2 – Disclosures - Relevant References

	Title	Section / Comment
A.	IFRS - Disclosure Initiative—Targeted Standards-level Review of Disclosures	General webpage for project.
B.	IFRS - Disclosure Initiative—Principles of Disclosure – Project Summary	Significant indication of IFRS approach.
C.	EFRAG/ANC/ FRC - Towards a Disclosure Framework for the Notes- Discussion paper (2012)	Key points of discussion are summarised over 2 pages – see paras 1-14
D.	FRC – FRS 101 Reduced Disclosure Framework	Note that specific disclosure exemptions are permitted for "A member of a group where the parent of that group prepares publicly available consolidated financial statements…" subject to (see para 5 C) disclosure of the exemptions utilised and information regarding access to the accounts of the group parent.
E.	FRC ISA 540 (UK) Auditing Accounting Estimates and Related Disclosures	Key reference for auditor regulatory compliance and risk management considerations