The Chartered Institute of Public Finance & Accountancy

report

Paper CLB 12 03_20

Board	CIPFA/LASAAC
Venue	CIPFA, Sowerby Room, 77 Mansell St, London E1 8AN
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Subject	Code Development – Materiality and Disclosures

Purpose

To consider potential actions on materiality and disclosure requirements in support of CIPFA/LASAAC's vision statement.

1 CIPFA/LASAAC Vision Statement and Background

1.1 The vision statement is:

"UK local authority annual accounts should be widely recognised as an exemplar for clear reporting of the financial performance and position of complex public sector bodies. Users of accounts should be able to access the information they want to help them to understand the finances of an authority and to take practical and informed decisions."

1.2 CIPFA/LASAAC previously considered a specific paper on materiality and disclosures in the June 2019 meeting (paper CL 07C 06-19). Amendments arising for the 20/21 Code primarily focused on:

- Implementation of IFRS amendments regarding the definition of materiality (IAS 1 and IAS 8) which emphasised that material information should not be obscured (eg through vague language; scattering of information (eg information on one topic not in one place); inappropriate aggregation/disaggregation; material information being hidden by immaterial information

- Specific reference to the requirement not to obscure information in relation to specific disclosures specified in the Code (eg valuation disclosures, fair value measurement disclosures, some pensions disclosures, some financial instrument disclosures etc)

1.3 The 20/21 Code ITC sought views on the inclusion of a disclosure checklist in the Code 20/21 for authorities to refer to (see FReM section below for the basis for this). Based on the responses received CIPFA/LASAAC considered it more appropriate to develop a disclosure principles framework for its own application in developing the Code requirements.

2 Materiality

2.1 The definition of materiality is specified in [IAS 1 Presentation of Financial Statements](#).

2.2 The Code currently includes the following:

"**Materiality** – information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific local 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, judgments 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".

2.3 The Code also includes paragraphs to indicate:

- material information should not be obscured
- the materiality of an item in a primary statement does not indicate a presumption that a specific supporting disclosure is material
- judgement should be based on user needs

2.4 CIPFA/LASAAC will wish to consider what further actions on materiality and disclosures are appropriate to support the vision statement, especially in relation to proposals for the 21/22 Code.

Items noted in the June Paper

2.5 Relating to aspects affecting vision statement achievement it was noted:

a) Materiality judgements should support and enhance the clarity of the accounts for readers, 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.

2.6 Relating to potential considerations the following were identified for consideration:

a) The need for judgements, by all parties, 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 or assessment 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

FReM Treatment

2.7 Chapter 8 of the 20/21 FReM does not specifically identify an adaptation or interpretation of the IFRS definition of 'material'.

2.8 The FReM para 7.6.3 states "In the public sector context, materiality can be by nature and context as well as in value, and the decisions of users can be of a non-economic nature."

2.9 The FReM may specifically adapt or interpret the specific requirements, including disclosures, specified in individual standards.

Identification of Users

2.10 User needs are a key component of CIPFA/LASAAC's vision statement, and in the application of materiality.

2.11 The strategic discussion paper sought views on whether clearer specification of the primary users of local government accounts and their needs would assist in making materiality decisions. It was questioned whether primary users could be specified as users interested in an authority's accountability for public resources.

2.12 The Code currently includes:

"the presentation of the financial statements shall meet the common needs of most users, focusing on the ability of the users to make economic decisions, the needs of public accountability and the stewardship of an authority's resources."

"therefore, for the purposes of Code, the primary users of the financial statements are service recipients and their representatives and resource providers and their representatives"

2.13 The FReM currently includes:

2.5.4 "The primary user of government annual reports and accounts is Parliament."

4.2.12 "The primary users of financial reporting identified in the IFRS Conceptual Framework are existing and potential investors, lenders and other creditors. By contrast, Parliament is the primary user of government annual reports and accounts, which enable Parliament to hold the government to account"

4.2.13 "Other users, as discussed in Chapter 2, include the public, researchers, relevant authorities, creditors, suppliers, and managers inside departments."

Whole of Government Accounts (WGA) Considerations

2.14 Any specific adaptation or interpretation of 'material' for local government will require careful consideration since it is a fundamental tenet of financial reporting. Any differential application across the public sector could have consequences for the ability to consolidate information for WGA purposes.

Regulatory Framework Considerations

2.15 The application of materiality is not only relevant for readers of the accounts but can also affect, and be affected by, the application of regulatory frameworks. Frameworks or regulators which rely upon information in the annual accounts may arguably be regarded as users of the accounts.

2.16 Additionally some regulatory frameworks may affect materiality application eg audit bodies, accountancy institutes (eg in relation to maintaining professional standards) and audit profession regulatory requirements may all influence behaviours and judgements regarding the application of materiality.

FRAB Consideration

2.17 At its November meeting FRAB noted the significance of the application of materiality in the public sector as a whole, with particular reference to asset valuations.

2.18 FRAB indicated that a public sector wide working group, with stakeholder involvement including relevant regulatory bodies, to consider the application of materiality in the public sector would be beneficial.

2.19 Such a working group could explore, as part of a potentially wider remit, the need and scope for amendments to the Code and the FReM to support public sector appropriate materiality judgements.

2.20 Another potential output may be a separate non-mandatory 'public sector materiality (good) practice statement' with backing from relevant stakeholders.

2.21 The timeline for such a project would not currently be anticipated to affect the 21/22 Code.

Recommendations:

- **That CIPFA/LASAAC support discussions with HM Treasury regarding the application of materiality; and the potential establishment of a public sector wide working group.**
- **The CIPFA/LASAAC consider whether further action to support materiality application should be explored in the 21/22 Code ITC.**

3 Disclosures

3.1 **An initial draft of a principles based approach for CIPFA/LASAAC assessment of disclosure requirements is provided in Appendix 2**. The remainder of this paper provides related information which is intended to support discussion and improvement of the proposed framework.

Items raised in the June paper

3.2 The June paper noted feedback relating to:

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

3.2 The paper also suggested that disclosures, for an item, could be focused to 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)

3.3 It was also 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 *[Added note: recent IFRSs more explicitly indicate the principle objectives in providing disclosures, supporting some judgement in identifying the disclosures which best meet those objectives].*

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.

20/21 Code Requirements

3.4 The Code includes various indications concerning the application of materiality to disclosures including:

> "A local authority need not provide a specific disclosure required by the Code if the information resulting from that disclosure is not material", which is cross referenced by a number of sections on disclosure requirements.
>
> Indicating that for some specific disclosures the risk of obscuring material information by providing immaterial information should be specifically considered.
>
> For IAS 19 in year curtailments etc, an indication of factors relevant for a proxy assessment quantitative materiality, but with no specification of threshold.

3.5 These were implemented in to support appropriate judgement and application of the concept and definition of material. CIPFA/LASAAC discussions highlighted that, ideally, such 'signposting' would not be necessary as the same judgement should apply to all information.

3.6 It was recognised that specific signposting for selected disclosures may lead to an assumption that all other disclosures are, by default, material. On balance CIPFA/LASAAC considered that at present signposting was required to make progress towards its vision statement.

FReM Requirements

3.7 The 20/21 FReM includes various aids and guidance to support appropriate disclosure decisions (see Appendix 1). The main area for discretion relates to annual report disclosures rather than annual accounts / financial statement disclosures.

3.8 This is indicated in the first question in a decision flowchart, which requires that if the relevant authorities require publication, the disclosure should be published. This is considered to reinforce the FReM, and other RA accounting manual, requirements.

3.9 The FReM (2.6.10) allows scope for cost benefit assessment to apply, but is clear in 2.6.11 this does not extend to mandatory requirements (eg standards based disclosures):

"However, reporting entities are not permitted to disregard mandatory reporting requirements due to value for money concerns. Instead, any such concerns should be raised with the appropriate relevant authority."

Charities SORP

3.10 The Charities SORP may also be a helpful reference to indicate other standard setter practices. Relevant extracts include:

2. "It is important for preparers of accounts to make reference to this standard when preparing accounts and in making the required disclosures."

4. "Preparers should refer to FRS 102 as the disclosures listed in this SORP are not exhaustive."

16 "Whilst this SORP has been prepared to be consistent with the requirements of company and other relevant law and regulation, charities will need to ensure that any particular accounting requirements and disclosures applicable to them are also met."

3.28 "a charity must…[]..make any additional disclosures required by the FRS 102;"

IFRS Projects

3.11 In response to concerns related to disclosure practices an IFRS Disclosure Initiative project was initiated. Following consultation and consideration a March 2019 paper Disclosure Initiative – Principles of Disclosure was issued.

3.12 The paper noted that the discussion paper had outlined seven principles that information in financial statements should reflect:

- entity-specific;
- described as simply and directly as possible;
- organised in a way that highlights important matters;
- linked, when relevant, to other information;
- not duplicated unnecessarily;
- provided in a way that optimises comparability; and
- provided in a format that is appropriate.

3.13 The paper indicated the IASB considered that developing specific Standards-level objectives would be more effective than developing centralised disclosure objectives.

3.14 Consequently guidance for the Board for the development of disclosures for standards was to be developed. This would be tested by the Board on selected specific standards.

3.15 A March 2020 meeting paper Targeted Standards-level Review of Disclosures sets out plans to issue an exposure draft during 2020 of:

- Draft guidance for the Board
- Proposed amendments to IAS 19 *Employee Benefits* (re defined benefit plans) and IFRS 13 *Fair Value Measurement*
    - *Note: potential IAS 19 proposals recognise the importance to users of future pension cash flows, rather than just the liability*

Resource Considerations

3.16 Based on CIPFA/LASAAC's vision statement the needs of users and providing clear information to meet those needs will be a primary considerations relating to disclosure requirements.

3.17 The vision statement document also however states "The Board will also recognise the resource constraints faced by local authorities and seek to provide succinct, clear and definitive guidance on relevant matters to assist CFOs in preparing clearer accounts."

3.18 Regarding resource constraints, and particularly relevant for disclosures, is the evidence base required to determine whether a specified disclosure is material for an entity. This can incur both preparer and audit process costs, regardless of whether the disclosure is made in the annual accounts.

3.19 Local government is particularly varied in nature across the UK with the financial transactions, and thus relevant accounting disclosures for any individual authority, potentially affected by:

- the legal framework in each administration
- the type of council
- the use of discretionary wide ranging powers (eg power of competence in England; power to advance well being in Scotland)
- the impact of local democratic decisions (eg regarding risk appetite in investing in commercial properties)
- the use of group arrangements(eg ALEOs - arm's length external organisations)
- the use of innovative approaches to achieving efficiencies in delivering public services (eg shared services; sale and leaseback etc)

3.20 Consequently it may only be in rare situations that CIPFA/LASAAC could securely conclude, at a UK level, that a particular IFRS disclosure is not relevant or appropriate for all UK local government bodies.

3.21 This raises the challenge that potentially all local government bodies have to demonstrate for a particularly wide range of IFRS disclosures, whether each disclosure is material. The resource and evidence base implications of this may be significant, and give rise to uncertainty and inconsistent practices. Regulatory expectations will also be a consideration in this.

Principles based framework for CIPFA/LASAAC disclosure assessment

3.22 Based on the above, an initial draft of a principles based disclosure assessment process is suggested in Appendix 2.

3.23 A key part of the framework is the proposed development of a 'standard set' of implementation options which are available to CIPFA/LASAAC.

3.24 Another important aspect of the potential framework is the development of an evidence based process in the event that an adaptation, or non-application, of an IFRS disclosure is to be discussed with FRAB.

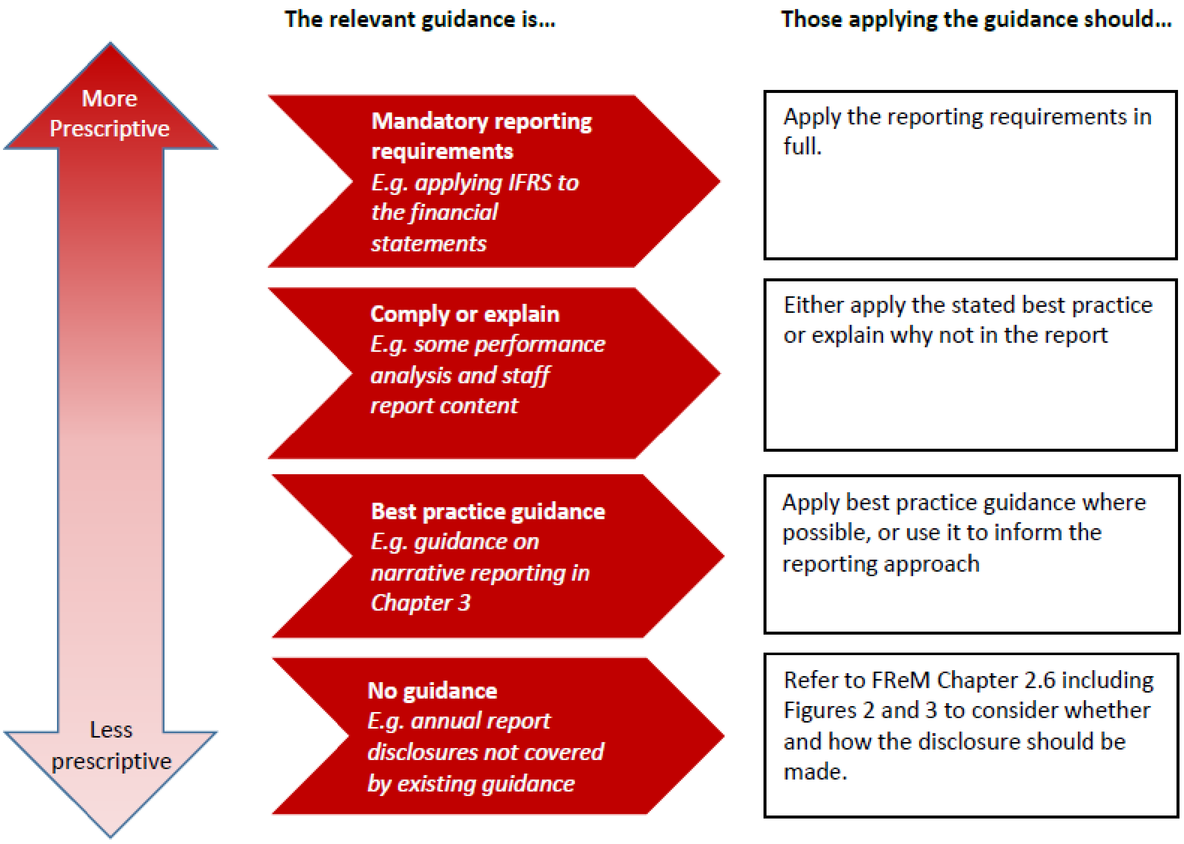
3.25 It should also be noted that the application of such a framework could be anticipated to be undertaken prior to formal consultation (ie be required before the ITC is issued). The ITC could be expected to act as a test of the proposed treatment of each disclosure.

Recommendations:

- **That CIPFA/LASAAC approves, or amends, the proposed principles based framework provided in Appendix 2.**
- **That CIPFA/LASAAC volunteers to further refine the framework are identified**

Disclosures: Selected FReM Indications of Requirements

1.4.4 Figure 1 shows the different levels of guidance, from more to less prescriptive, and how they should be applied to develop high quality financial reports.



All requirements introduced with 'shall', or audited, are mandatory. Note that audit requirements may vary for entities under different relevant authorities. For requirements that are not mandatory, the guidance states explicitly when it should be applied on a comply or explain or best practice basis.

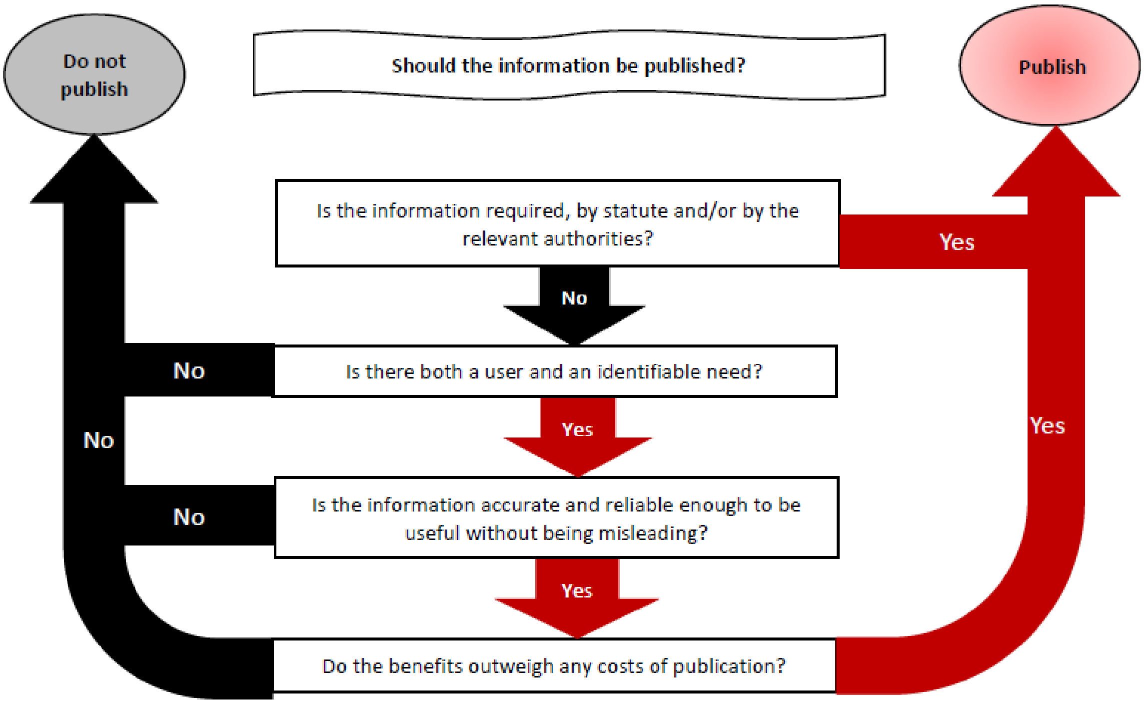


Figure 2: disclosure decision tree part 1

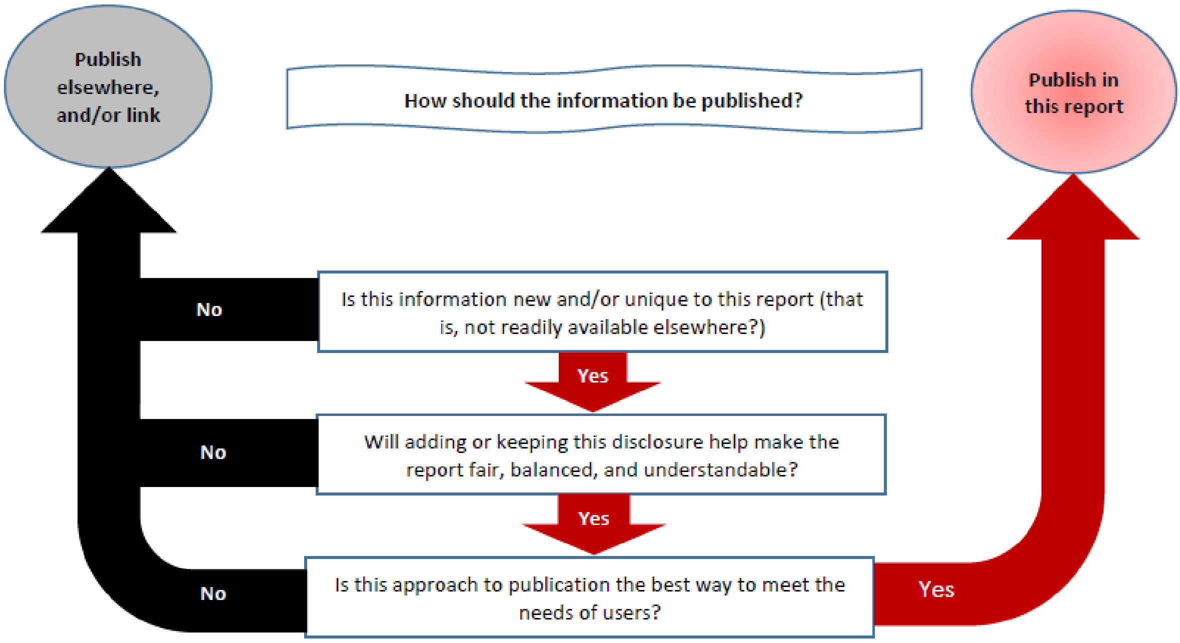


Figure 3: disclosure decision tree part 2

Balancing cost and usefulness in reporting

2.6.10 Every disclosure in a set of annual reports and accounts comes with a cost. Relevant authorities consider the cost of reporting when interpreting or adapting reporting standards and developing guidance. All government bodies have a duty to use public resources well, and Accounting Officers should therefore also consider value for money when making the judgements about financial reporting that fall into their remit.

2.6.11 However, reporting entities are not permitted to disregard mandatory reporting requirements due to value for money concerns. Instead, any such concerns should be raised with the appropriate relevant authority.