Queensland Government

Queensland Treasury
Financial Reporting Requirements for Queensland Government Agencies

FRR 2B Materiality

INTRODUCTION

Policy items, indicated by **shaded bold print**, form the Minimum Reporting Requirements (MRRs).

Pursuant to sections 38(2) and 39(2) of the *Financial and Performance Management Standard 2019* (FPMS), departments and statutory bodies must prepare their financial statements in accordance with the MRRs. All of the MRRs are mandatory for departments. Statutory bodies comply with the FPMS by applying the parts of the MRRs that are considered relevant to their circumstances.

Application Guidance, indicated by plain text under the "Application Guidance" sub-headings, provides support on interpreting and applying the mandatory policy items and other matters.

Illustrative Examples demonstrate the application of the FRR policy items to hypothetical scenarios.

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2B.1 AASB PRACTICE STATEMENT ON MATERIALITY

REFERENCES

- *Framework for the Preparation and Presentation of Financial Statements (FPPF)*
- *Conceptual Framework (CF)*
- SAC 1 *Definition of the Reporting Entity*
- *AASB Practice Statement 2: Making Materiality Judgements*
- AASB 101 *Presentation of Financial Statements*
- AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*
- Auditing Standard ASA 320 *Materiality in Planning and Performing an Audit*

POLICY

- **The overarching concepts of the Framework, AASB Practice Statement 2: *Making Materiality Judgements* and the Application Guidance below must be taken into account in the preparation of agency annual financial statements.**

APPLICATION GUIDANCE

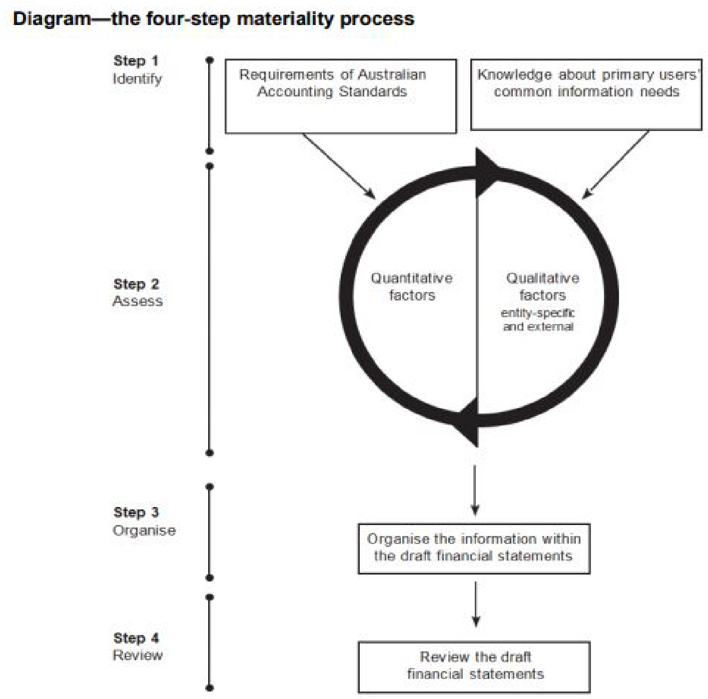
Application of the AASB Practice Statement: Making Materiality Judgements

This FRR is aimed at assisting agencies apply the materiality framework established in Practice Statement 2. Agencies should note the Practice Statement is not an Australian Accounting Standard. Rather, the application requirements of the Practice Statement mean entities are required to consider its application when making materiality judgements that are required under applicable Accounting Standards. In the absence of other authoritative publications, Treasury expects Queensland Government Agencies will follow the guidance contained in Practice Statement 2 when making materiality judgements, unless specific guidance is otherwise contained within this or another Financial Reporting Requirement (FRR) issued by Queensland Treasury.

Making Materiality Judgements – Overview of the Materiality Process

The AASB Practice Statement on materiality contains a four-step illustrative process as part of the guidance that describes how an entity could assess whether information is material for the purposes of recognition, measurement, presentation and disclosure. Although this is considered guidance within the Practice Statement, and paragraph 30 notes this is one possible way to make materiality judgements, it does incorporate all of the factors an entity should consider when making materiality judgements and the requirements an entity must apply to comply with Accounting Standards.

Paragraph 34 – AASB Practice Statement 2: Making Materiality Judgements



<u>Materiality in the Context of Financial Reporting</u>

Unless there is an explicit statement that disallows it, materiality is an overarching principle that applies to the preparation of financial statements and the application of Australian Accounting Standards, Australian Interpretations and accounting/reporting policies (including the Financial Reporting Requirements and Non-Current Asset Policies).

It is not possible to specify a blanket or uniform quantitative threshold for materiality or predetermine what could be material in a particular situation. Materiality is an entity-specific assessment and is both quantitative and qualitative in nature.

<u>Identifying Primary Financial Statement Users: Not-for-Profit Agencies</u>

Not-for-profit agencies should be aware of a broader range of primary users and the fact their resource allocation/decision making process may differ <u>compared to a for-profit entity</u>. (refer to paragraphs Aus13.1 and Aus18.1 of the Practice Statement, and paragraphs AusOB2.1 and AusOB3.1 of the Framework)

<u>Quantitative and Qualitative Considerations</u>

Materiality is a matter of professional judgement on quantitative and/<u>or</u> qualitative grounds and demands a complete understanding of the specific facts and broader context/circumstances. Quantitative grounds are applicable to transactions and balances (and adjustments thereto) that are expressed in dollar terms. Other (e.g. narrative) information disclosed in notes that accompany the financial statements is generally more appropriately assessed based on its nature. However, where an assessment based on either of those bases is inconclusive, it is usually necessary to make a judgement from both perspectives overall.

<u>Quantitative Aspects (Amount)</u>

Paragraphs Aus45.1 to Aus45.3 of the Practice Statement identify that not-for-profit entities are primarily concerned with the achievement of objectives (i.e. service delivery) other than the generation of profit. <u>Consequently, not-for-profit entities will typically assess materiality using a base other than profitability</u>. Common examples of alternatives bases include total revenue, total expenses, total assets and net assets.

Having regard to the need to consider the effect of cumulative materiality judgements (refer to FRR 2B.2), but when determining whether a transaction/balance/error/adjustment is material on quantitative grounds, the following comparisons (whichever apply) may provide a useful and reasonable starting point for agencies in the decision making process:

- for amounts that would be reported in the Statement of Comprehensive Income, compare to the more appropriate of the following amounts for the relevant reporting period:
  - the line item in which the amount would be included; or
  - total income or total expenses (as applicable); or
  - operating result (as applicable).

- for amounts that would be reported in the Statement of Financial Position/Balance Sheet, compare to the more appropriate of the following amounts for the relevant reporting period:
  - the line item in which the amount would be included; or
  - total assets, total liabilities or total equity (as applicable).

- for amounts that would be reported in the Statement of Cash Flows, compare to the more appropriate of the following amounts for the relevant reporting period:
  - the line item in which the amount would be included; or
  - total inflows or total outflows (as applicable) for the relevant cash flow category (i.e. operating/investing/financing); or
  - net cash provided by/used in the relevant cash flow category (i.e. operating/investing/financing).

- for amounts that would be reported only in the Statement of Changes in Equity, compare to the total of the line item in which the amount would be included in for the relevant reporting period. For amounts also reported in the Statement of Comprehensive Income, it will be necessary to refer to the relevant comparator within that statement.

Agencies should be alert to items/amounts/comparators for the current reporting period that are considered to be distorted by one or more transactions/events (e.g. due to their amounts being unusually high or low, or amounts being recognised in an irregular pattern across financial years). In such cases, it may be necessary to adjust the materiality calculation for the distortion to obtain a more reasonable and appropriate result.

When assessing materiality, not-for-profit agencies may also need to consider 'directly related' items as part of making materiality judgements. For example: interest expense to relevant borrowings or depreciation/amortisation to related assets. Such a comparison may suggest that interest or depreciation expense is material if its amount is much lower (or higher) than expected, having regard to the relevant asset/liability balance and applicable interest/depreciation rates.

Qualitative Aspects (Nature)

Qualitative factors are factors that, if present, make information more likely to influence the decisions of the primary users of the entity's financial statements irrespective of their amount. The presence of a qualitative factor lowers the thresholds for the quantitative assessment of the particular materiality judgement being made. The more significant the qualitative factors, the lower the quantitative threshold will be. In some circumstances, qualitative factors may be so significant that the quantitative threshold for a particular type of transaction is reduced to zero.

Where the item is information in a narrative/non-numerical form and/or does not impact on reported financial statement figures, materiality will require assessment based on the nature of the transaction/balance/information.

Not-for-profit public sector agencies are primarily concerned with the achievement of organisational and governmental objectives (such as service delivery) rather than the generation of profit. Therefore, where the nature of a particular transaction, balance or narrative disclosure is important for the discharge of accountability or transparency, the nature of the item is likely to be material.

Consideration of the “nature” usually relates to whether the information would be of public interest such as:

- transactions between an agency and other entities/people who have a fiduciary responsibility in relation to that agency;
- restrictions on powers and operations of an agency that significantly affect the risks and uncertainties associated with the item concerned;
- substantial changes in the functions of an agency, affecting its risks and opportunities;
- potential breaches of legislative or contractual obligations;
- significant post-balance date events; and
- special payments, or losses of assets.

The FRRs set out a number of individual items that must be disclosed in the financial statements on this basis – e.g. key management personnel compensation disclosure at the position level, losses and special payments. The quantitative materiality threshold would be significantly reduced (or potentially zero) for these items. There may be other items unique to certain agencies that warrant disclosure due to their nature, so agencies should use their judgement as to the public interest in the separate disclosure of such items.

Interaction of Quantitative and Qualitative Factors

As illustrated in the AASB Practice Statement and process diagram, qualitative and quantitative factors are interactive and a quantitative assessment alone is not always sufficient to conclude that an item of information is not material. Therefore, when quantitative judgments of materiality indicate a transaction, balance, or adjustment is not material to the financial statement as a whole, an assessment of qualitative factors would also be made to ensure the appropriateness of that conclusion.

2B.2 MATERIALITY STRATEGY

REFERENCES

- *AASB Practice Statement 2: Making Materiality Judgements*

APPLICATION GUIDANCE

Making materiality judgements - determining and documenting materiality

For the purposes of financial statement preparation, agencies will need to determine and document (early in the financial year) a materiality strategy to be used by the agency.

In setting the materiality strategy, agencies should discuss with external audit and understand the materiality levels established by the auditors and how they will be applied in the context of the audit. However, agencies should not simply adopt the materiality levels used by audit. **Materiality set by the agency is expected to be lower than that set by the auditors.**

This materiality strategy should be endorsed by the Audit Committee (or equivalent management body that oversees the financial statement process) and would be expected to include, at a minimum, the following assessments:

- The materiality levels for the agency as a whole and each individual financial statement;
- The materiality to be applied to a department's administered transactions/balances, noting the reporting requirements for such transactions under the FRRs. Consequently:
  - Where administered transactions are disclosed as separate statements, a separate materiality threshold would be determined for the controlled and administered financial statements;
  - Where administered transactions are disclosed as a note within the controlled financial statements, agency judgement will be required as to whether a separate materiality threshold is required for those administered disclosures.
- Where applicable, materiality considerations for the valuation of property, plant and equipment where such balances are disproportionally larger than revenues and expenses reported in the operating statement and any revaluation adjustments will only impact the balance sheet of the agency. (N.B. where revaluation amounts are reported in profit or loss / operating result, it will be necessary to apply the thresholds determined for the Statement of Comprehensive Income and/or overall financial statement materiality against those transactions).

- Materiality thresholds for disclosures that are qualitatively material such as:

  - *Compliance with laws/regulations (e.g. losses/special payments under the FPMS or other legislative impacts on the agency)*;
  - *Related party transactions and Key Management Personnel remuneration*;
  - *Other sensitive transactions/balances or disclosures.*

- Other thresholds/benchmark judgements *(*as appropriate). For example, agencies may identify individual assets within an asset class that need not be revalued because they are immaterial to the class of asset. Agencies should document the basis for that decision and its interaction with other materiality judgements.

In addition to the materiality assessments, an effective materiality strategy identifies:

- the anticipated primary users of the agency's financial statements;

- the expected information needs of those users, according to the agency's activities and the relevance of transactions/balances to those anticipated users (SAC 1 and the Framework may provide some guidance in this respect);

- tolerable (quantitative) limits the entity will use to record unadjusted items in a register for facilitate an assessment of the cumulative impact of these individual immateriality judgements, which should be tabled by management when the audit committee approves the financial statements;

- approaches for dealing with comparators for the current reporting period that are considered to be distorted by one or more transactions/events (e.g. due to their amounts being unusually high or low, or amounts being recognised in an irregular pattern across financial years). In assessing materiality under those circumstances, agencies should consider the appropriateness of either excluding unusual transactions/balances from the relevant current year comparator, or calculating a new comparator figure based on an average over a number of past reporting periods;

- the areas in the financial statements that are likely to require a greater level of disclosure and determining which areas will require the greatest (or possibly the least) effort in preparing workpapers/documentation to support the financial statements; and

- the way the above factors will direct materiality judgements by the agency in respect of each statement (in light of the guidance in this FRR.)

Correct use of materiality for financial statement preparation

The materiality strategy and thresholds set by the agency for use in preparation of the financial statements should not be misapplied or used out of context. For instance, they should not be applied to day-to-day accounting entries (such as recording transactions and processing journals) to avoid recognising transactions below a certain threshold. All transactions must be recorded, however the accounting for them (e.g. whether to recognise an asset or an upfront expense) is subject to materiality.

Making materiality judgements - Agency monitoring of materiality

Materiality for the financial report as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that have affected the agency. For example, a machinery-of-government change, a restructure or a decision to dispose of a major part of the agency's business or cease particular service delivery outcomes. Such changes will often cause actual financial results to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial report as a whole.

In addition, during the course of the year, as separate judgements are made to not process adjustments, etc. on the basis of this strategy (i.e. on the grounds of immateriality), agencies should keep a register of the nature of the instance, the reason for the decision, and the quantitative effect on the financial statements. The intention of this register is to monitor the "cumulative" effect of past individual materiality decisions on the financial statements.

Where the cumulative effect of those decisions starts becoming material, agencies are expected to revisit those past decisions, and process adjustments to the extent that there will not be a material impact on the financial statements.

"Cumulative" materiality judgements

Materiality on quantitative grounds is primarily assessed for an individual transaction/balance or adjustment. However, agencies need to also assess the cumulative impact of multiple transactions/balances/adjustments that are individually assessed as being immaterial. Where individually immaterial transactions/balances/adjustments would have a material impact when aggregated, the agency needs to instead treat those transactions/balances/adjustments as being material.

For example, an immaterial error is made in accounting for a transaction. A similar immaterial error is subsequently repeated on other transactions for the remainder of the financial year, before it is identified and a procedure change implemented to prevent the error's recurrence. The cumulative amount of the errors is assessed as being material and, without any adjustment, the financial statements will include a material misstatement. Ideally, each error should be corrected. However, to prevent material misstatement, the agency may only need to correct a sufficient number of those errors for the cumulative effect to be immaterial and to no longer impact the fair presentation of the financial statements.

Materiality of a controlled entity

In those less common situations where materiality of a controlled entity needs to be assessed to determine whether it requires inclusion in the consolidated figures, comparisons should be made between the figures of the parent entity (or existing economic entity where consolidated financial statements are already prepared) and those of the controlled entity regarding total assets, total liabilities, total income and total expenses.

In making this comparison, a controlled entity may be determined as being individually immaterial. However, where an agency has multiple individually immaterial controlled entities, an additional comparison (using the same comparators) is required to ensure those entities collectively are not material in aggregate.

Where individually immaterial controlled entities are material in aggregate, the agency must determine which of those entities should be consolidated. This requires the exercise of professional judgement using the materiality comparators in respect of the figures for each controlled entity. Unless another method provides a more reliable basis, the agency should consolidate the entities in order of their relative materiality until the (remaining) unconsolidated controlled entities are no longer material in aggregate.

Where a parent entity has unconsolidated entities (on the grounds of immateriality), the above assessment will need to be repeated towards the end of each financial year to ensure that the unconsolidated controlled entities continue to be immaterial in aggregate.