Te Kāwai Ārahi Pūrongo Mōwaho
EXTERNAL REPORTING BOARD

# EXPLANATORY GUIDE A7: MATERIALITY FOR PUBLIC BENEFIT ENTITIES (EG A7)

**Issued May 2014**

This Explanatory Guide provides guidance to public benefit entities in applying materiality to presentation and disclosure when preparing general purpose financial reports in accordance with PBE Standards issued by the New Zealand Accounting Standards Board (NZASB).

This Explanatory Guide is an explanatory document and has no legal status. It was issued in May 2014 and updated in November 2017.

ISBN 978-1-927292-13-6

## CONTENTS

## EXPLANATORY GUIDE A7: MATERIALITY FOR PUBLIC BENEFIT ENTITIES

## 1. Purpose of this Explanatory Guide

### Introduction

1. The objective of this Explanatory Guide is to help public benefit entities (PBEs) apply the concept of materiality to presentation and disclosure in general purpose financial reports, hereafter referred to as "financial reports". It is intended to help preparers of financial reports fulfil the overall objective of financial reporting which is to provide users with high quality financial and non-financial information, for accountability and decision-making purposes.

2. The term "material" is defined in paragraph 7 of PBE IPSAS 1 *Presentation of Financial Statements*[1] as follows:

> Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments of users made on the basis of the financial statements. Materiality depends on the nature and size of the omission or misstatement judged in the surrounding circumstances. The nature or size of the item, or a combination of both, could be the determining factor.

3. Many decisions about the materiality of information to be presented or disclosed are clear. However, there are circumstances where professional judgement about the materiality of presenting or disclosing information is important. Those judgements can involve considering both the effect of including information in, and excluding information from, financial reports.

4. This Explanatory Guide explains the materiality judgements that are required when preparing financial reports. Applying materiality judgements requires that the following be considered:
   (a) Who the users of financial reports are, and what their information needs are.
   (b) How the qualitative characteristics affect presentation and disclosure.
   (c) How the nature and size of items of information, judged in the surrounding circumstances, affect presentation and disclosure.
   (d) Where financial and non-financial information that is material should be presented and disclosed.

5. Materiality requires the exercise of professional judgement and needs to be determined based on the surrounding circumstances. It is a concept that cannot be predetermined by bright-line rules, such as using percentages or benchmark numbers. This Explanatory Guide is designed to help PBEs[2] – in the public sector[3] and the not-for-profit sector[4] apply that professional judgement.

### Scope

6. This Explanatory Guide applies to financial reports which include financial statements,[5] non-financial information such as service performance information and supplementary information. Financial reports for other purposes such as those prepared for revenue authorities are outside the scope of this Explanatory Guide. Preparers of financial reports make judgements about materiality when making decisions about the recognition, measurement, presentation and disclosure of information. Although decisions about materiality are important in each of these areas, the focus of this Explanatory Guide is on applying materiality to the presentation and disclosure of both financial and non-financial information in financial reports.

---

[1] See Appendix for further occurrences of material and materiality in PBE IPSAS 1. PBE FRS 48 *Service Performance Reporting*, issued in November 2017 and effective for annual financial reports covering periods beginning on or after 1 January 2021, changed the title of PBE IPSAS 1 to *Presentation of Financial Reports* and amended the definition of material by adding a reference to service performance information.

[2] PBEs are reporting entities whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders.

[3] PBEs in the public sector are those entities defined as public entities in the Public Audit Act 2001.

[4] PBEs in the not-for-profit sector are public benefit entities that are not PBEs in the public sector.

[5] A complete set of financial statements normally includes a statement of financial position, a statement of comprehensive revenue and expense, a cash flow statement, a statement of changes in net assets/equity, a comparison of budget and actual amounts (when the budget is made publicly available) and notes to the financial statements. The statement of comprehensive revenue and expense may be presented in two statements, being the statement of financial performance and the statement of other comprehensive revenue and expense.

7. The materiality of items to be presented and disclosed in financial reports should be considered whenever an entity prepares financial reports. Decisions about materiality should also be considered when a new entity is reporting for the first time, or when an existing entity is transitioning to a set of accounting standards which were not previously required for that type of entity. Materiality decisions are also important when an entity intends to reduce the size of the financial report by reviewing the relevance of the information in the financial report as a whole.

8. Materiality affects the whole financial report, including the notes. Although financial reports are prepared after the end of the reporting period, and final materiality decisions are made at that point, considering materiality throughout the financial year can help ensure that the right information is available on a timely basis for the financial report. Therefore, materiality should be considered in the planning phase of the financial reporting cycle, with particular attention to the level of aggregation and disaggregation.

## 2. Users of Financial Reports and their Information Needs

**Users of Financial Reports**

9. The objective of financial reports is to provide a wide range of users (who would not otherwise have access to the information) with financial and non-financial information that is useful for accountability or decision-making purposes.

10. The attributes of users should be considered when determining the materiality of particular items. It is assumed that users:

    (a) Understand the purpose of financial reports;

    (b) Understand that financial reports include estimates and require the preparer to exercise judgement about future events;

    (c) Have a reasonable knowledge of the activities of the reporting entity; and

    (d) Have the willingness, and ability, to study the reported information in the entity's financial reports with a degree of diligence.

11. Users of public sector financial reports include:

    (a) Current and potential resource providers such as taxpayers, ratepayers, financial institutions, employees, and suppliers;

    (b) Current and potential service recipients;

    (c) Parties performing a monitoring function such as central government agencies;

    (d) Elected representatives such as Ministers of the Crown, Members of Parliament, and local body councillors; and

    (e) Members of the public.

12. There are also intermediary user groups in the public sector (for example, financial journalists representing taxpayers, and unions representing employees of the public sector).

13. Users of not-for-profit financial reports include:

    (a) Current and potential resource providers such as providers of grants and donations (including taxpayers),[6] members of the entity, financial institutions, employees, volunteers and suppliers;

    (b) Current and potential service recipients;

    (c) Parties performing a monitoring function such as regulators; and

    (d) Members of the public.

14. There are also intermediary user groups in the not-for-profit sector (for example, associations representing philanthropists, financial journalists representing those who contribute to public fundraising, such as street appeals, and unions representing employees in the not-for-profit sector).

**Users' Information Needs**

15. When preparing financial reports information should be presented in a way that is helpful to users for accountability and decision-making purposes. Information for accountability purposes will not necessarily be the same as information for decision-making purposes. PBE Standards specify the information to be reported to users of PBE financial reports to meet their needs.

16. User needs vary, so judgement is required to determine whether certain needs should be met in a financial report. PBE IPSAS 1 explains that separate presentation of a class of similar items or disclosure of particular items is required only if the class of items or the individual item is material. This is the case even if a particular PBE Standard contains a list of specific requirements or describes them as minimum requirements. If a particular item does not satisfy user needs then it fails the materiality test, and does not need to be disclosed. Some factors to consider are outlined below.

[6] Taxpayers can receive tax credits for donations made to charities.

17. Information for accountability purposes is important to users of PBE financial reports because of the indirect relationship that usually exists between the provider of funds (such as the taxpayer, ratepayer or donor) and the recipient of services. For example, the general public is the recipient of public goods such as policing services, while the resource provider is the taxpayer (through the payment of general taxes). There is no direct link between the taxes paid and the policing services delivered. The taxpayer is dependent on financial reports for information about how taxes have been spent (including on policing services).

18. Other providers of resources to PBEs, such as donors, may also rely on financial reports for information to establish accountability. For example, a not-for-profit entity raising donations from the public through a street appeal is generally considered to be accountable to those donors for the use of that money, including the costs of fundraising.

19. Information for decision-making purposes is also important to users of PBE financial reports. For example, members of a sporting club might rely on financial reports to decide whether they will support an increase in membership fees, or whether they will continue to belong to the club.

20. A key attribute of the PBE sector is the importance of information about the current and future service performance of the reporting entity for decision making. This is because the dimension of performance that users of PBE financial statements are commonly most interested in, is the delivery of services by the entity (rather than return on equity as is the case in the for-profit sector). The PBE Standards are designed to ensure that an entity's achievement of its objectives is reflected in the statements of service performance, financial performance and financial position. Service performance information should also be considered from a materiality perspective to ensure that the best information is available to users to satisfy their information needs.

## 3. How the Qualitative Characteristics affect Presentation and Disclosure

21. It is important to consider the qualitative characteristics when making materiality judgements about the information to present and disclose in a financial report. The *Public Benefit Entities' Conceptual Framework* (PBE Conceptual Framework) explains the qualitative characteristics that apply to financial and non-financial information.

22. These qualitative characteristics are:

- Relevance;
- Faithful representation;
- Understandability;
- Timeliness;
- Comparability; and
- Verifiability.

22.1 Materiality is classified as a constraint on information included in GPFRs. The materiality of an item should be considered when determining whether the omission or misstatement of an item of information could undermine not only the relevance, but also the faithful representation, understandability or verifiability of financial and non-financial information presented in GPFRs.

23. Financial and non-financial information is relevant if it is capable of making a difference in achieving the objectives of financial reporting. This means that materiality operationalises relevance at the entity level. Presentation and disclosure of irrelevant information leads to "clutter" in financial reports and might obscure the relevant information. Judgements about the exclusion of information can be just as important as the decisions on what additional information to disclose, and how best to disclose it to maximise the benefits of the information to users.

24. Faithful representation affects judgements about presenting and disclosing information. As financial reports include information based on estimates and judgements, faithful representation does not mean that information must be precise. Where information included in primary statements is based on estimates and judgements, disclosing additional information about the basis for the estimates and judgements, including risks, can be material to a user's assessment about the faithful representation of the information.

25. Understandability also affects judgements about presenting and disclosing information. Complex matters should not be excluded just because they may be difficult for some users to understand without assistance. However, preparers should facilitate the understanding of material matters by the way information is presented and disclosed in financial reports. Disclosure in the notes can provide context to the information presented in the primary statements, thereby enhancing understandability. Removing immaterial disclosures can improve understandability (and relevance), and focuses readers of financial reports on the aspects of performance that are important for accountability and decision making.

26. Comparability can be an important characteristic if material disclosures show trends over time that are helpful to users for making decisions about the entity. Material information can also facilitate comparisons across the sector in which the entity operates.

26.1 In order to be verifiable, the assumptions that underlie the information disclosed, the methodologies adopted in compiling that information, and the factors and circumstances that support any opinions expressed or disclosures made should be transparent. Materiality judgements will need to be made to determine how much information to disclose to enable users to form judgements about the appropriateness of those assumptions and the method of compilation, measurement, representation and interpretation of the information.

## 4. How Size and Nature affect Presentation and Disclosure

27. The decision as to whether or not financial and non-financial information is material is determined by:

    (a) The size of the item of information; and

    (b) The nature of the item of information.

    Both these factors need to be considered based on the surrounding circumstances at the time of reporting.

28. Sometimes, size or nature may be the primary determinant of materiality. At other times, materiality judgements can involve the interplay between nature and size. Materiality judgements often take an holistic view: they are more about the understanding of the interactions between the factors based on the surrounding circumstances, rather than trying to identify the particular factor that will determine whether a disclosure is material or not.

**Size of Information**

29. One determinant of materiality is the size of an item. Size is usually considered on a relative basis to determine whether an item is large enough to affect either users' accountability assessments or users' decisions. If the item is large relative to other items, and significant in terms of its effect on the reader's evaluation of an entity's performance or position, then it is likely that it is material and should be separately presented or disclosed. If not, then it is likely that separate presentation or disclosure would be immaterial.

30. A common practice is to think about materiality by referring to some benchmark measure, for example *x*% of expenses. Although this may be helpful, the main judgement is still around the usefulness of the information to the users of financial reports. Care should be taken not to be overly reliant on quantitative measures in forming a judgement.

31. Selecting the appropriate degree of aggregation or disaggregation of information is also important. An individual item may not be of a size that is considered material, but it may be when aggregated with other similar items. Often similar items will be aggregated, and materiality applied to the aggregated information. However, sometimes within aggregated information, there are individually material items for which separate presentation and disclosure is warranted. For example, if total fundraising income is presented as a separate line item, and if one large donation contributes to 75% of the total, it may be appropriate to separately disclose this. Disaggregation of information should be considered when it provides more relevant information to the users for decision making and accountability.

**Nature of Information**

32. Another determinant of materiality is the nature of an item. If the nature of an item is important to accountability assessments or decision making then its disclosure is likely to be material. A financial or non-financial item can be material based on its nature, irrespective of its size. Some financial items, (such as related party transactions involving members of the entity's governing body on more favourable terms and conditions than anyone else) although small, might by their nature be important to readers of an entity's financial report. Similarly, some of the services delivered by an entity, (and reported in the statement of service performance) although a small part of an entity's operations, might by their nature be important to readers.

33. In the not-for-profit sector, fundraising costs is a common example of an item where the nature of the item means that it is important to the users of financial reports. The level of donors' interest in the cost of fundraising by not-for-profit entities means that information about this item could be material regardless of the size of that item.

34. Similarly in the public sector, an example of an item that is likely to be material based on its nature is a failure to operate within the statutory authorities established for the entity. This is likely to be important information for users of the financial report. Another example where nature rather than size is important is the failure by an entity to comply with bank covenants related to borrowing in situations where that failure has not been remedied by the end of the reporting period.

35. The circumstances surrounding an entity may prompt the need for a material disclosure. For example, if an entity has investments in other entities the individual investments may not be material. However, if in a given year one of these other entities experiences financial difficulties, information about the investment in that entity is likely to be material to users of the investing entity's financial reports as it may affect their evaluation of the investing entity's financial position or performance.

36. Changes in an entity's circumstances might also lead to the materiality of information being reassessed. For example, a museum holds some art works primarily for public display, but sells the occasional work when it is surplus to requirements. Such sales are not generally viewed as being material. However, if due to a decline in its financial position, the museum decides to put a proportion of its collection up for sale, this fact, and the subsequent sale proceeds, might become material due to the different circumstances in which the sale is made. If one of these sales is a painting of national significance that is sold to an overseas buyer, this may result in widespread media coverage focusing on the loss to New Zealand of a heritage asset. These circumstances may be considered material enough to justify separate disclosure. However, intense media interest should not always be the trigger for detailed disclosure. It may be appropriate to summarise the surrounding circumstances, and disclose some information to satisfy user needs for financial reporting.

37. Preparers should also consider if there are other more appropriate avenues for disclosure of certain high profile items that do not meet the user needs test for inclusion in an entity's financial report. For example, an agency may provide information about the chief executive's expenses on its website, or be required to disclose information in a publicly available register such as the *Register of Pecuniary and Other Specified Interests of Members of Parliament*.

38. The nature of the item can also impact on the extent of detail required to meet user information needs. For example, some information about the response of a public sector entity to a large natural disaster could be expected to be presented and disclosed. Users are likely to be interested in the impact of this event on financial performance and position, but that does not mean that extensive detailed information needs to be disclosed. However, no reference to this event is likely to result in the omission of material information.

39. Care should be taken in making materiality judgments about the public interest. The purpose of financial reporting is to provide information about the entity's performance and position for accountability and decision-making purposes. Some information may be desired by users when motivated by media disclosures, but this does not necessarily mean that they are part of user information needs for financial reporting purposes.

## 5. Where Financial and Non-financial Information should be Presented and Disclosed

40. Once it is established that a particular item of information is material, the next judgement is where to present or disclose that item. The options are:

    (a) Presentation on the face of the financial statements; or

    (b) Disclosure in the notes.

41. The options for the presentation and disclosure of non-financial information are more limited. Most information is presented in the statement of service performance, but it is also possible to disclose some non-financial information in the notes.

42. PBE Standards require that some information be presented on the face of the financial statements (provided that the information is material). Preparers of PBE financial reports have no choice on the location of this information.

43. However, in many cases PBE Standards do not specify the location of information. In these cases preparers of PBE financial reports should consider whether the primary statements or notes are the most appropriate location for that information. Some factors to consider are:

    (a) The purpose of the financial report is to provide the overall "picture" of the entity's service performance, financial position, financial performance and cash flows. Too much information in the primary statements can create "clutter" that may obscure the overall story.

    (b) The purpose of the notes is to provide additional or disaggregated information to support the information provided in the primary statements. It is therefore of a supplementary nature, and is there to enhance readers' understanding of key aspects of the detail to clarify the overall picture.

44. In deciding where to present and disclosure information about particular assets, liabilities, revenues, expenses or other changes in net assets/equity, preparers of PBE financial reports should consider whether that information is essential to presenting the overall picture of the entity's performance (where presentation in the primary statements is the preferred option) or whether it is a disclosure which supports and explains the overall picture (where disclosure in the notes is the preferred option).

45. Some factors to consider about presentation and disclosure are:

    (a) Materiality applies equally to information disclosed in the notes and presented in the primary statements;

    (b) More information is not always better (the qualitative characteristics of relevance and understandability apply);

    (c) Presenting or disclosing immaterial information can obscure important material; and

    (d) The level of aggregation, and order in which information is disclosed in the notes, can enhance the relevance, understandability and comparability of financial and non-financial information.

46. Once the need for disclosure in the notes is established, the quality and the quantity of information to be disclosed should be carefully considered. The notes are not intended to be a repository for any information related to a material item reported in the primary statements. Each disclosure in the notes should be material in its own right.

47. Undue duplication should be avoided. Whilst it is necessary to cross-reference from the primary statements to the notes, repetition of information adds to the clutter and is often unnecessary.

48. The way in which a material disclosure is presented in the notes can enhance understandability. For example, the order of disclosures, highlighting new information, showing larger items first, or grouping related items can all enhance understandability.

## 6. Summary

49. Assessing the materiality of items of information for possible presentation and disclosure in the financial report requires professional judgement to be exercised. Part of that judgement is the decision about whether to present items in the primary statements or disclose items in the notes.

50. PBE IPSAS 1 makes it clear that an item is material when it could influence decisions of users. An item is required to be presented or disclosed only when it is material. Material items which are similar in nature should be presented or disclosed together to enhance understandability.

51. Exercising judgements about materiality is an important part of the process of preparing financial reports. More disclosures do not always result in better information for users of those reports. Applying materiality judgements should result in more useful and understandable financial reports.

52. When making judgements about whether items of information are material and should therefore be presented and disclosed, the following should be considered:

(a) Who the users of financial reports are, and what their information needs are.

(b) How the qualitative characteristics affect presentation and disclosure.

(c) How the nature and size of items of information, judged in the surrounding circumstances, affect presentation and disclosure.

(d) Where financial and non-financial information that is material should be presented and disclosed.

## Appendix: References to Materiality in PBE Standards

A number of PBE Standards and related documents refer to materiality. Links to the relevant PBE Standards and related documents, together with paragraphs references are shown below.

***Public Benefit Entities' Conceptual Framework***

| **Topic** | **Paragraph Number(s)** |
|---|---|
| Materiality | 3.32, 3.33, 3.34 |

**PBE IPSAS 1 *Presentation of Financial Statements*[7]**

| **Topic** | **Paragraph number(s)** |
|---|---|
| Definitions – Material | 7 |
| Materiality | 13 |
| Going Concern | 38 |
| Materiality and Aggregation | 45–47 |
| Offsetting | 51 |
| Identification of the Financial Statements | 65 |
| Reporting Period | 68 |
| Statement of Comprehensive Revenue and Expense | 98.4 |
| Information to be Presented either on the Face of the Statement of Comprehensive Revenue and Expense or in the Notes | 106 |
| Disclosure of Accounting Policies | 136–138 |
| Key Sources of Estimation Uncertainty | 140–144, 146 |
| **Appendix C: Service Performance Reporting**<br>Appendix C is guidance that accompanies, but is not part of, PBE IPSAS 1. | |
| PBE Conceptual Framework | C5 |
| Reporting Issues – Keys to High Quality Reporting | C78 |
| Reporting Variances | C87 |

[7] PBE FRS 48 *Service Performance Reporting* changed the title of PBE IPSAS 1 to *Presentation of Financial Reports* and amended the definition of material by adding a reference to service performance information. It also deleted Appendix C.

**PBE IPSAS 3** ***Accounting Policies, Changes in Accounting Estimates and Errors***

| **Topic** | **Paragraph number(s)** |
|---|---|
| Materiality | 8 |
| Selection and Application of Accounting Policies | 10,12 |
| Changes in Accounting Policies | 21 |
| Errors | 46–47 |

**PBE IAS 34** ***Interim Financial Reporting***[8]

| **Topic** | **Paragraph number(s)** |
|---|---|
| Other Disclosures | 16A |
| Materiality | 23–25 |
| Disclosures in Annual Financial Statements | 27 |
| Use of Estimates | 41 |

**PBE FRS 48** ***Service Performance Reporting***

| **Topic** | **Paragraph number(s)** |
|---|---|
| Principles | 6–10 |

[8] PBE FRS 48 *Service Performance Reporting* amended the discussion of materiality in paragraphs 23–25.

## History of Amendments

EG A2 *Materiality for Public Benefit Entities* was issued in May 2014.

This table lists the date of amendments to EG A7 and provides a brief summary of those amendments.

| **Month** | **Summary of amendments** |
|---|---|
| November 2017 | • Editorial amendments<br>• Updated for qualitative characteristics per the *PBE Conceptual Framework* |