MATERIALITY IN FINANCIAL REPORTING

An Integrative Perspective

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BY

FRANCESCO BELLANDI

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INVESTOR IN PEOPLE

To Anna, constant presence and support

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About the Author

Francesco Bellandi, US CPA (Certified Public Accountant); CGMA (Certified Global Management Accountant); Dottore Commercialista (Italian Chartered Accountant); Diploma in International Financial Reporting from the ACCA (The Association of Chartered Certified Accountants, UK); Degree in Economics (summa cum laude), LUISS University; M.B.A., SDA Bocconi School of Business, Bocconi University; Diploma in Private Equity from the A.I.F.I. (Italy's private equity association).

Francesco Bellandi is a practitioner in US GAAP/IFRSs dual reporting. Named by the AICPA as a worldwide IFRS US GAAP Subject Matter Expert, *he is a member of the AICPA, the NYSSCPA (New York State Society of Certified Public Accountants), the NYSSCPA's International Accounting & Auditing Committee where he has chaired the IFRS and the FASB subcommittees. He has been an Editorial Review Board Member of The CPA Journal, New York, USA.*

Francesco Bellandi is a forensic auditor. *He has served as a board director,* chief financial officer, and finance director in several multinational companies around the globe and contract university professor in Audit and in IFRS.

He has authored several publications, including two books published by Wiley & Sons, 2012: *The Handbook to IFRS Transition and to IFRS U.S. GAAP Dual Reporting* and *Dual Reporting for Equity and Other Comprehensive Income under IFRS and U.S. GAAP.*

He can be reached at francesco_bellandi@yahoo.com *or* francesco.bellandi@dualgaap.com.

Preface

For financial statement neophytes, materiality looks like a philosophical issue, thought to be of little importance to practitioners and financial statements preparers adept to hard life. Yet, most of the internal management battles for what to filter through the internal reporting layers and what and how to disclose it in the external financial statements run on the verge of materiality.

Experienced financial statements preparers know that much of the discussion at the top management and board levels is on what to or not to present and disclose, justified on the grounds of materiality, but often for some other reason indeed. Auditors know that unless they can prove that a misstatement is material, their bullet would be smoothed. And if they did uncover something, they would pray that it was immaterial. Forensic analysts are aware that when a company says that something is not material, this alone is a good reason to investigate what this statement is trying to conceal.

Materiality is a slippery issue. Being so difficult and tricky, the FASB appears determined not to search for its definition in an accounting context. Standard-setters must serve a large audience, from preparers to investors. But preparers, indeed, are also among their stakeholders. They must find some trade-off: accounting is not for scientists and cannot be so difficult to be impossible or excessively costly. So, preparers push for materiality, invoking users, but really do users invoke materiality? Is this license too wide? It depends on how sophisticated the glasses of readers are, and from what angle they are viewing the scene. What could seem a departure from GAAP may in essence be acceptable as — somebody heard the auditor saying — it is not material. In a win-win situation, proving immateriality may give apparent relief to management for light sins and on the other hands be a useful defense to auditors. Investors, at least the most sophisticated of them, and financial analysts would rather have more information, because they know how to decide what is material to them. Securities regulators are obviously stricter than standard-setters.

Take it to the limit, somebody may have said after the fact, that it was too an immaterial issue to be of interest to users, and so this statement would be used to prove that before the fact there was an intent of fraud. The Court may have to say the last word.

This book offers an integrated perspective of materiality from the different angles of accounting standards for annual, interim, and segment reporting (including IFRS, US GAAP and SEC Rules and Regulations), auditing standards (including US and international ones), internal control over financial reporting, management commentary, financial analysis and management control, forensic analysis, sustainability reporting, corporate responsibility, assurance standards, integrated reporting, and limited legal considerations.

Part I introduces the background, including the scenario of the current debate as part of the IASB's Disclosure Initiative, the FASB's Disclosure Framework and the SEC's Disclosure Effectiveness Initiative.

Part II contrasts the views of the accounting conceptual frameworks. It then compares the definition of materiality in different standards and contexts, to then draw a taxonomy of materiality and its attributes.

Part III reviews the uses and effects of materiality as an accounting, legal, audit, and managerial concept. It counterbalances the interests and positions of the various stakeholders involved, such as investors, preparers, standard-setters, auditors, regulators, financial analysts, and other users of the financial statements. It then capitalizes on the author's vast experience in industry to devise alternative and complementary models of materiality with their pros and cons.

Part IV provides readers with interlinked guidance in accounting and audit about the extant requirements for the application of materiality to recognition, measurement, presentation and disclosure in the financial statements. It also expands to issues that are typical of management commentary. It informs about the complexities and subtle differences between financial statements and bookkeeping on the subject. Two full sections cover the application of materiality in auditing and in internal control over financial reporting, respectively.

Part V of the book goes into the details of how to assess materiality. It draws from a plethora of different disciplines to go to the essence of the very meaning and application of professional judgment and its multifaced aspects in specific scenarios and decisions. This section goes into practical guidance that rarely can be found on a such judgmental topic.

Part VI illustrates different approaches concerning the processes and methods that an entity can establish to determine materiality. Given the highly subjective nature of materiality assessments, proper processes, systems and methodologies are at the forefront of the recent and future developments in this area.

Part VII tackles specific issues of application of materiality. This section includes an illustration of SEC Staff comments on materiality in the review of Form 20-F of foreign private issuers and a checklist of specific accounting pronouncements relating to specific materiality decisions.

Part VIII of the book wraps up the whole content in showing how an experienced professional can handle discussions with management to uncover inappropriate schemes, manipulation tactics, if not frauds.