APPLYING THE MATERIALITY CONCEPT: THE CASE OF ABNORMAL ITEMS

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Abstract

Materiality is a key concept in accounting theory and practice. Yet differing views exist in regard to the practical application of the materiality concept amongst preparers, auditors, users of financial reports and regulators (ESMA/2011/373). Unlike International Accounting Standards, in Australia AASB 1031 *Materiality* addresses materiality thresholds.

The pre-2000 period, when Australian firms were required to separately disclose abnormal items in their financial reports, provides a unique opportunity to explore how the concept of materiality was applied. Abnormal items were considered abnormal by reason of their size and effect on operating earnings. We investigate whether immaterial or marginally material items were classified as abnormal, and whether materiality thresholds were consistently applied to different types of abnormal items and over time.

Findings show almost a quarter (22.94%) of abnormal items were immaterial for which the overall mean was only 2.54% of the baseline earnings before abnormal items. Results are consistent when abnormal items are classified into the four predominant types by which described in financial reports and when further dissected into the forty categories by which they were themed. The outcomes of this analysis inform the current regulatory debate concerning the inclusion of immaterial items in financial reports which may mislead users (FRRP 2013) and the IASB materiality project (2013)**.

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1 Introduction

Materiality is a key concept in the theory and practice of accounting (Messier, Martinov-Bennie and Eilifsen, 2005) and is of critical importance in the preparation of financial statements as it impacts on many decisions, including whether items of income or expense should be separately presented (ESMA/ 2011/373). Materiality thresholds are used as the dividing line between material and immaterial information (Iskandar and Iselin, 2000). Whilst the concept of materiality is generally well understood there is diversity in its application which appears "to be widespread amongst preparers, auditors, possibly users of the financial reports and, in some instances, accounting enforcers" when applying IFRS (ESMA/2011/373: 4).

The diversity in the application of materiality has recently come to the forefront as a topical issue with several International regulatory bodies undertaking projects that address materiality. In October 2010 the Institute of Chartered Accountants of Scotland (ICAA) and the New Zealand Institute of Chartered Accountants (NZICA) delivered their report 'Losing the Excess Baggage' in which they concluded that more emphasis should be given to the correct application of the materiality concept in financial reporting.

In July 2012 the European Financial Reporting Advisory Group (EFRAG), The Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC) published the Discussion Paper (DP) 'Towards a Disclosure Framework for the Notes' of which one aim was to discuss and obtain feedback on strengthening the application of materiality. Responses to the DP noted that there was strong support for application guidance on materiality.

August 2012 saw The European Securities and Markets Authority (ESMA) publishing a 'Summary of Responses' (ESMA/2012/525) to their November

2011 consultation paper 'Considerations of Materiality in Financial Reporting' pre-empting the public roundtable held in October 2012 (ESMA/2013/218).

More recently, materiality was also a discussion point at the January 2013 IASB hosted 'Discussion Forum on Disclosures in Financial Reporting'. Ian Mackintosh, Vice-chairman IASB advised the forum there was general support from constituents for more guidance on the application on materiality. The materiality issue stems further than just ensuring 'material' items are disclosed but also that immaterial items are not disclosed as the inclusion of immaterial items may mislead users to conclude that these items are material (FRRP, 2013).

According to the IASB Framework, for information to be useful for decision-making it must be relevant, and relevance of information is affected by its nature and materiality (para. 29). Information is considered material if "its omission or misstatement could influence the economic decisions of users..." (IASB Framework, para.30). "Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances", which needs to be considered for items on an individual or collective basis (IAS1/AASB 101, para. 7). Thus, there is considerable latitude that can be exercised by preparers in their judgment of whether items are material. For example, applying the IAS1/AASB 101, (para. 97) disclosure requirement "when items of income or expense are material, an entity shall disclose their nature and amount separately", means that the materiality of the item has to be judged on the basis of its amount, its nature, and whether it is material as a single item, or material only in combination with other items.

Paragraph 98 (IAS1) states that items that would give rise to the separate disclosure of items of income and expense include:

(a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;

(b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;

(c) disposals of items of property, plant and equipment;

(d) disposals of investments;

(e) discontinued operations;

(f) litigation settlements; and

(g) other reversals of provisions.

However, separate disclosure of such items is not necessarily useful to users in the absence of further explanation in regard to why the item is considered material and about what inferences can be drawn from whether the item is part of, or outside income from 'normal' operations.

Prior to 2001, Australian companies were required to separately disclose any items that were outside an entity's normal operations and classify these items as 'abnormal'. Under the version of AASB 1018 *Profit and Loss Accounts* that was in operation at that time, items of revenue and expense were classified as 'abnormal' based on their size and effect on net income. AASB 1018 did not provide any specific explanation or threshold measure that could be applied in determining what the minimum relative size of an item should be before it should be classified as 'abnormal'. However, it was commonly understood that the amount of the item would be material to warrant abnormal classification. AASB 1031 *Materiality*[6] provides specific quantitative thresholds to guide preparers in their materiality judgements when preparing financial statements and states that items greater than 10% of a base amount are material. Accordingly, if the test for separate disclosure of items as 'abnormal' is their size relative to net income, it would be expected that only items that are clearly material (more than 10% of net income) would be classified as abnormal. However, prior research provides evidence of immaterial items being reported as abnormal (see Cameron and Gallery 2008).

The pre-2000 period, when Australian firms were required to separately disclose abnormal items in their financial reports, provides a unique opportunity to explore how the concept of materiality was applied. Thus the objective of this paper is to investigate whether immaterial or marginally material items were being classified as abnormal, and whether materiality thresholds were consistently applied to different types of abnormal items and over time. The outcomes of this analysis potentially inform the current debate on regulatory requirements for disclosure of material items and non-disclosure of immaterial items.

Our findings show only 61.2% of individual abnormal items reported exceeded the 10% materiality threshold whilst almost a quarter (22.94%) of abnormal items were immaterial for which the overall mean was only 2.54% of the baseline earnings before abnormal items. Furthermore, at the highest level of aggregation, nearly 15% (14.78) of net abnormal items were immaterial with an overall mean of 2.35% of the baseline earnings before abnormal items. The results

[6] At the time of writing AASB 1031 *Materiality* is in the process of being withdrawn from the suite of Australian Accounting Standards. Background to that withdrawal is: "As noted in the Preface to AASB1031 Materiality (July 2004), at the time AASB1031 was issued the Framework for the Preparation and Presentation of Financial Statements contained limited guidance on materiality in comparison to AASB1031. Accordingly, as part of the AASB's implementation of the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1January 2005, the AASB decided to retain AASB1031, in a revised format, to ensure that the meaning of materiality remained well explained.
The AASB has a policy of not providing unnecessary local guidance on matters covered by IFRSs. As a consequence, the AASB decided to withdraw AASB1031 as was proposed in AASB Exposure Draft
ED243 Withdrawal of AASB1031 Materiality. In making its decision to withdraw AASB1031, the Board noted that it would not expect the withdrawal to change practice regarding the application of materiality in financial reporting. In particular, the withdrawal of AASB1031 would not change the level of disclosure presently specified by other accounting standards."

are consistent when abnormal items are classified into the four predominant types by which they are described in financial reports: Provisions, Charges, Restructure and Income, and when further dissected into the forty categories by which abnormal items were themed.

Findings from this study suggest that preparers applied a lower materiality threshold than that recommended in the materiality accounting standard AASB 1031. Given that items were required to be judged only on the basis of *size* in determining whether the item was classified as abnormal, these results suggest that during the pre-2000 period there was widespread 'misclassification' of items as abnormal, which could have led to confusion about the items. Now that current accounting standards require disclosure of material items to be based on either *size* or *nature*, there is even more scope for confusion as users are not given an indication of which criterion has been applied.

Our research contributes to the current debate as to whether the concept of materiality is consistently applied in the preparation of financial statements. The U.K. Financial Reporting Review Panel (2011) suggested that the disclosure of immaterial items in financial reports may mislead users as immaterial items may be perceived by users as being 'material' and is encouraging firms to apply a quantitative threshold when preparing financial statements. However, our results provide evidence that even in the presence of regulated quantitative thresholds, managers apply lower materiality thresholds than those recommended in the accounting standard. We also contribute to discussion around the issues raised by the ESMA (2012; 2011), which specifically sought comments pertaining to whether the concept of materiality is clearly and consistently applied in practice by preparers. Whilst respondents to ESMA/2011/373 overall considered the concept of materiality to be generally well-understood, many were of the view that there was diversity in its application. This study provides evidence of such diversity in that the application of materiality has not been consistently applied in the Australian corporate financial reporting context.

The paper proceeds a follows. The next section presents the Institutional background of AASB 1031 M*ateriality*, its application in the context of abnormal items and our research questions. The data and methodology used in this study is then presented. This is followed by our results and then concluding comments.

2 Institutional background and research questions

Australia has had a standard specifically dealing with materiality dating back to 1969 when a professional standard was first issued by the Institute of Chartered Accountants in Australia, and then moved from a professional standard to a legally enforceable standard when AASB 1031 was issued in 1995. When Australia adopted International Financial Reporting Standards in 2005, it retained and added to the suite of internationalised standards the existing standard: AASB 1031 *Materiality*.

Whilst minor revisions have been made to AASB 1031 over time, the definition of materiality has remained relatively constant:

When AASB 1031 was first issued in 1995, it defined materiality as:

materiality means, in relation to information, that information which if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by the management or governing body of the entity (para. 5)

With the adoption of Australian equivalents to IFRS in 2005, AASB 1031 was revised and reissued, defining 'material' as:

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

Although the 2005 AASB 1031 definition includes reference to the nature of an item which was not in the pre-2005 definition, the guidelines over time have continually referred to the nature as follows:

In deciding whether an item or an aggregate of items is material, the nature and amount of the items usually need to be evaluated together. In particular circumstances, either the nature or the amount of an item or an aggregate of items could be the determining factor (AASB 1031, para. 12).

and

it may be necessary to treat as material an item or an aggregate of items which would not be judged to be material on the basis of the amount involved, because of their nature. (AASB 1031, para. 12 (b))

Thus, the concept of materiality has two criteria: 'size' and 'nature' and preparers exercise their discretion in determining whether items are material in accordance with these criteria. In terms of the nature of an item, it is likely that there will be significant diversity as to the relative importance of such items among preparers. In the absence of any specific guidance, what may be deemed as material by one preparer may be deemed immaterial by another.

In relation to the size criterion, AASB 1031 (and the preceding standard AAS 5) does include

quantitative thresholds as guidance when considering the materiality of the amount of an item:

(a) *an amount which is equal to or greater than 10 per cent of the appropriate base amount may be presumed to be material unless there is evidence or convincing argument to the contrary; and*

(b) *an amount which is equal to or less than 5 per cent of the appropriate base amount may be presumed not to be material unless there is evidence, or convincing argument, to the contrary.*(AASB 1031, para.15)

In summary, amounts of 10 per cent or greater are material and amounts 5 per cent or less are immaterial. The standard is silent on items falling between 5 per cent and 10 percent, inferring professional judgement needs to be exercised.

Turning to abnormal items in the context of materiality, AASB 1018 (which was operative pre-2000) defined abnormal items as:

items of revenue and expense included in the operating profit or loss after income tax for the financial year, which are considered abnormal by reason of their size and effect on the operating profit or loss after income tax for the financial year (AASB 1018, para. 9) (emphasis added)

The words "abnormal by reason of their size and effect" infer that only unusually large items would be classified as abnormal. The standard made no reference to the 'nature' of items and therefore whether an item was abnormal was to be determined solely on the basis of its 'size'. Furthermore, the words "size and effect on the operating profit or loss after income tax" clearly state the appropriate base for determining materiality in the context of abnormal items is the operating profit or loss after income tax for the financial year. However, AASB 1018 did not provide any clearly defined or specific explanation, nor any threshold measure or guidance statements for determining what the minimum relative size of an item should be in order to meet the 'abnormal by reason of its size and effect' test.

Given that AASB 1018 did not provide any guidance on the minimum size that an item needed to be to be classified as 'abnormal', it can be assumed that the item had to be sufficiently material to warrant the abnormal item (AI) classification. Given that *any* items that exceed the AASB 1031 quantitative materiality thresholds have to be separately disclosed in financial reports, for an item to have been classified and disclosed as 'abnormal' under AASB 1018, its size would need to have at least exceeded the AASB 1031 materiality threshold. Accordingly, items equal to or greater than 10 per cent of the profit/loss would be 'material' and met the 'size and effect' test; whereas items equal to or less than 5 per cent of the profit/loss were immaterial and should have been precluded from being reported as an AI. Rather, it would be assumed that any items that did not meet the AASB 1031 quantitative thresholds but were separately disclosed were considered material due to their 'nature'. Such items could not be classified as abnormal, because the 'nature' of the item was not a criterion for classifying abnormal items; the only criterion was 'size'.

Returning to the AASB 1018 definition of abnormal items, that is, 'abnormal by reason of their size and effect on the operating profit or loss after income tax' infers the item has to meet a size and effect test in order to be classified as abnormal. A question that arises here is whether the abnormal classification test of 'size and effect' was consistently applied. Given that the inclusion of immaterial amounts in the financial statements can mislead users (Financial Reporting Council, U.K., 2011), disclosure of abnormal items that did not at least meet materiality size thresholds would suggest items were misclassified as abnormal for purposes other than providing useful information to financial statement users. Therefore, our research questions are:

1. Was the size and effect test consistently applied to the different types of items classified as abnormal?

2. *Was the frequency of immaterial, marginally material and material abnormal items consistent over time?*

3 Data and Methodology

The sample is drawn from Cameron and Gallery (2008) comprising 321 companies that reported one or more abnormal items (AIs) during the seven-year period from 1994 to 2000, yielding 907 firm-years. The amount and description of each individual AI reported in each of the 907 firm-years was hand-collected from annual reports, yielding in total 2,258 individual AIs. Expense AIs were grouped into three common types Provisions[7], Charges and Restructures[8], and with Income AIs group, made four types. The AIs falling within each of the four broad types were then categorised into common themes based on the description provided in the annual report, as presented in Table 1. A total of 234 AIs described as a 'Provision' are categorised into six categories; 984 AIs described as that are 'Charges' are categorised into 19 categories; 322 AIs described as 'Restructure' form one category; and 718 Income AIs are grouped into 14 categories; that makes an overall total of 40 categories.

Recall, AASB 1031 states that the *amount of an item or an aggregate of items* could be the determining factor in determining materiality. Thus, preparers in deciding whether items classified as 'abnormal' met materiality thresholds (size test) could have assessed materiality of AIs by assessing the materiality (size effect) of an individual item on the operating profit or loss after income tax for the financial year; or by aggregating AIs.[9] In terms of

[7] Any AI using the word 'provision' in the description

[8] AIs described as Restructuring Provisions are included in the 'provisions' category

[9] It should however be noted that AASB 1018 refers only to classification of individual items as abnormal and makes no reference to aggregating items. Therefore, strict application of

aggregating AIs there are three possible levels of aggregation that preparers could have used: (1) aggregating like items (e.g. adding two or more provision items together and then assessing the aggregate size effect); (2) aggregating all expense AIs into one group and all income AIs into another; and (3) totalling all AIs by netting off expense AIs and income AIs. Hence, our analysis considers the application of materiality thresholds to the classification of AIs at the individual item level and for each of the three possible aggregate levels.

To address the first question of whether the size and effect test was consistently applied to the different types of items classified as abnormal, we calculated the ratio of each AI to the reported Operating Profit after Income Tax before Abnormal Items (OPBATBAI). Table 1 shows descriptive statistics by AI category and for each of the AASB 1031 materiality thresholds: those that are less than 5% of OPBATBAI are immaterial; the materiality of those falling in the range of 5% and less than 10% of OPBATBAI are in the 'grey' area where professional judgement needs to be applied; and those that are equal to or greater than 10% of OPBATBAI are material. Following the analysis of individual items, we examine materiality based on each of the three levels of aggregations.

4 Results

Table 1 shows that for our sample of firms reporting abnormal items between 1994 and 2000, just over two-thirds (68.2%) of the 2258 items reported as abnormal are expense items, of which Charges are the most common (43.6%), followed by Restructure at 14.3% and Provisions at 10.4%. Income AIs account for nearly a third (31.8%). Category 8 'costs written-off/down or expensed' is the most common abnormal item (n = 176) in the Charges category, representing 17.9% of that group. Category 28 described as 'profit on sale of investments/shares/securities is the most common type of Income AI (n = 166), representing 23.1% of that group. What is apparent from Table 1 is that all categories have a spread of items that are immaterial (<5% of OPATBAI) in magnitude failing the 'size and effect' test of AASB 1018.

In relation to the materiality of the AIs, Table 1 shows that 518 (22.9%) of the total abnormal items fall below the 5% immaterial threshold, with an overall mean (median) ratio of 2.5% (2.5%) of OPATBAI. Within the four major categories of AIs, the proportion ranges from 17.9% for Provisions to 25.8% for Restructure. This high proportion of immaterial items being classified and disclosed as 'abnormal' indicates that misclassification of items as abnormal was common.

A smaller proportion of the AIs fall into the 'grey' materiality area (15.9%), with proportions by category ranging between 14.5% for Charges and 19.6% for Restructure. The question is whether these items met the size and effect test. It would be reasonable to assume that to meet that criterion the item should be clearly material in terms of its size, that is, greater than or equal to 10% of OPATBAI. The mean (median) ratio of 7.4 (7.2) suggests that most, if not all, of those items were immaterial. Overall, only 61.2% of items exceed what could be considered the clearly material threshold of 10%, with Provisions the highest proportion (65%) and Restructure the lowest (54.7%). The mean (median) ratios of 421.5% (36.9%) of OPATBAI indicate considerable dispersion in the monetary amounts of the AIs.

Our results clearly indicate that preparers did not always interpret 'size and effect' to mean that the item is material. It is apparent that the 'size and effect' criterion of AASB 1018 was not applied consistently, suggesting that the nature of the item may have come into consideration, but this is inconsistent with definition of abnormal items in the accounting standard AASB 1018.

Figure 1 presents the materiality proportions of AIs within each AI type reported in Table 1. If we apply 'material' in magnitude in its strictest form (=>10% of OPATBAI), 61.2% of AIs were material, but cumulatively nearly 40% (38.8%) of AIs did not meet the size and effect test of AASB 1018 as they were <10% of OPATBAI. Figure 1 shows that a greater proportion of AIs are <5% of OPATBAI than those that are marginally material in the grey area of 5% to 10% and is consistent for each of the four types of AIs. Overall, 22.94% would be deemed immaterial in magnitude according to AASB 1031 (<5% of OPATBAI) compared to 15.86% in the 5%-10% grey area of AASB 1031.

Recall, under AASB 1031, materiality is required to be considered for items on an individual or aggregate basis. Hence firms may have considered the size and effect of AIs on OPATBAI at an aggregate level rather than singularly for each individual item. Table 2 presents descriptives for three possible levels by which abnormal items could have been aggregated. Aggregate level (1) is the aggregate of like items, that is, aggregate provisions; aggregate charges; aggregate restructure and/or aggregate income AIs reported by a firm in a given year. Aggregate level (2) is all expense AIs reported by a firm in a year aggregated into one group and all income AIs into another. Aggregate level (3) is the aggregate total of all AIs, which represents the net amount of AIS (i.e. netting off all expense AIs and all income AIs).[10]

the standard would require application of the size and effect test individual items only and not on aggregations of AIs

[10] By way of explanation, total observations for the aggregated levels will not equal the total of all individual AIs as reported in Table 1. For example the total observations for individual provisions will be more than the aggregated total provisions observations because aggregations are at the firm-year level. Hence where a firm reports more than a single provision in a firm-year, these will be aggregated and shown as aggregate provisions for the firm year

Table 1. Descriptive statistics by Abnormal Item Category and Materiality Level Based on the Ratio of Abnormal Item to OPATBAIs (1994 – 2000)

		<5%				5%-<10%				>10%				Total	
Cat. No.	Abnormal Items Described As:	N	% of Category	Mean	MD	N	% of Category	Mean	MD	N	% of Category	Mean	MD	N	% of N=2258
	PANEL A: PROVISIONS														
1	Doubtful Debts On Loans/Receivables	3	9.1	3.9	3.8	9	27.3	7.8	8.3	21	64	40.5	22.4	33	
2	Diminution In Value Of Shares/Investments	7	13.5	2.6	3.3	9	17.3	7.4	7.4	36	69	476.8	57.3	52	
3	Provision For Write-Down Of Assets	7	28.0	3.7	3.7	5	20.0	6.1	6.2	13	52	90.6	39.5	25	
4	Closure/Rationalisation/Restructuring Of Business Activities	7	26.9	2.2	2.2	4	15.4	7.0	6.8	15	58	34.2	28.7	26	
5	Restoration And Rehabilitation	3	20.0	3.8	4.2	3	20.0	7.5	6.8	9	60	550.1	39.3	15	
6	Other Provisions	15	18.1	2.3	2.0	10	12.0	7.6	7.8	58	70	285.4	45.8	83	
	TOTAL PROVISIONS	**42**	**17.9**	**2.8**	**2.9**	**40**	**17.1**	**7.4**	**6.9**	**152**	**65**	**271.1**	**39.5**	**234**	**10.4**
	PANEL B: CHARGES														
7	W/D/ W/O Diminution Of Investments	13	20.6	2.57	1.76	13	20.6	8.2	8.4	37	58.7	103.0	30.7	63	
8	Costs W/O Or W/D Or Expensed	51	29.0	2.77	2.75	27	15.3	7.1	6.9	98	55.7	281.1	35.9	176	
9	Write-Off/Down Of Intangibles	3	16.7	2.53	2.25	2	11.1	5.3	5.3	13	72.2	329.5	102.2	18	
10	Write Down/Off Of Property Plant & Equipment	11	25.0	2.82	2.7	10	22.7	6.8	6.8	23	52.3	161.0	25.1	44	
11	Accelerated Depreciation/Amortisation On Assets	4	21.1	2.76	2.82	3	15.8	7.3	6.1	12	63.2	3379.1	38.5	19	
12	W/D Or W/O Of Assets	28	19.6	2.42	2.25	20	14.0	7.9	8.0	95	66.4	970.6	51.6	143	
13	Write Off/Down Of Receivables	3	13.0	3.03	3.3	4	17.4	7.1	7.2	16	69.6	92.0	39.4	23	
14	Write Down Of Group/Loans To Controlled Entities & Losses On Sale Controlled Entities	6	14.3	1.14	0.78	8	19.0	7.3	7.8	28	66.7	118.9	39.7	42	
15	Loss On Sale Or W/D Of Assets	25	38.5	2.16	1.98	10	15.4	7.1	6.5	30	46.2	188.0	36.6	65	
16	Loss On Disposal Of Investment	16	69.6	2.18	1.95	0	0.0			7	30.4	130.7	82.6	23	
17	Foreign Exchange/Currency Losses	3	10.7	2.23	2.99	3	10.7	8.1	7.6	22	78.6	328.5	24.8	28	
18	Litigation/Arbitration/Settlement Costs	11	23.9	2.82	2.91	13	28.3	7.3	6.7	22	47.8	115.4	26.5	46	
19	W/D, W/O:Exploration, Evaluation & Development Costs	6	7.9	1.39	1.02	0	0.0			70	92.1	632.2	137.7	76	
20	Write-Off Of Goodwill	4	9.1	2.74	2.85	5	11.4	5.9	5.3	35	79.5	306.8	67.5	44	
21	Tax Rate	11	36.7	2.01	1.59	6	20.0	6.9	6.4	13	43.3	24.4	19.5	30	
22	Year 2000 & GST Compliance Costs	20	64.5	2.55	2.74	5	16.1	7.5	6.7	6	19.4	17.8	16.5	31	
23	Merger/Takeover Bid/Response Costs	8	29.6	2.4	2.35	4	14.8	8.2	8.7	15	55.6	46.5	25.2	27	
24	Other Forms Of Losses	5	20.0	3.93	4.06	1	4.0	5.6	5.6	19	76.0	149.6	48.1	25	
25	No Applicable Category Of Charges	11	18.0	2.88	2.68	9	14.8	8.2	8.9	41	67.2	246.5	23.0	61	
	TOTAL CHARGES	**239**	**24.3**	**2.49**	**2.45**	**143**	**14.5**	**7.4**	**7.2**	**602**	**61.2**	**435.5**	**43.1**	**984**	**43.6**
26	**PANEL C: RESTRUCTURE**	**83**	**25.8**	**2.77**	**2.93**	**63**	**19.6**	**7.1**	**7.0**	**176**	**54.7**	**450.2**	**25.8**	**322**	**14.3**
	PANEL D: INCOME AIs														
27	Profit On Sale Of Land/ Buildings/Property	21	32.3	2.1	1.9	13	20.0	6.8	6.9	31	47.7	148.9	23.2	65	
28	Profit On Sale Of Investments/Shares/ Securities	31	18.7	2.7	2.6	25	15.1	7.5	7.3	110	66.3	191.4	37.9	166	
29	Profit On Sale Of Businesses/Business Activities	27	31.0	2.2	2.1	12	13.8	8.2	8.8	48	55.2	164.8	71.6	87	
30	Legal/Warranty/Damages/Insurance Settlements	4	20.0	2.8	2.6	4	20.0	7.0	6.8	12	60.0	6029.8	47.4	20	
31	Profit On Sale Of Assets	4	9.5	2.3	2.6	5	11.9	6.3	6.2	33	78.6	1589.4	35.2	42	
32	Gains On Foreign Currency/Exchange Translation	2	6.7	2.8	2.8	5	16.7	6.6	6.2	23	76.7	240.3	32.8	30	
33	Interest/Dividend/Bounty/Grant/Fee Income	5	12.5	1.9	1.2	11	27.5	6.6	6.3	24	60.0	48.4	29.2	40	
34	Tax Items	14	25.5	3.1	3.5	11	20.0	7.3	6.9	30	54.5	131.6	28.0	55	
35	Write-Backs	24	30.4	2.4	2.5	9	11.4	7.2	7.3	46	58.2	127.3	48.5	79	
36	Revaluation Gains/Increments	5	29.4	2.1	1.5	1	5.9	8.3	8.3	11	64.7	108.7	24.9	17	
37	Profit/Gains On Sale Of Controlled Entity/Equity Interests	2	4.7	3.5	3.5	4	9.3	8.0	8.2	37	86.0	95.0	42.9	43	
38	Agreements	1	7.7	1.3	1.3	0	0.0			12	92.3	152.7	32.4	13	
39	Gains On Debt Defeasance/Refinancing	4	23.5	1.9	2.0	1	5.9	7.5	7.5	12	70.6	2521.9	71.1	17	
40	Other Gains	10	22.7	3.4	3.3	11	25.0	7.3	7.1	23	52.3	1262.4	46.5	44	
	TOTAL INCOME AIs	**154**	**21.4**	**2.5**	**2.4**	**112**	**15.6**	**7.3**	**7.1**	**452**	**63.0**	**531.7**	**38.8**	**718**	**31.8**
	TOTAL EXPENSE AIs	**364**	**23.6**	**2.6**	**2.5**	**246**	**16.0**	**7.3**	**7.2**	**930**	**60.4**	**370.1**	**35.6**	**1540**	**68.2**
	TOTAL AIs	**518**	**22.9**	**2.5**	**2.5**	**358**	**15.9**	**7.4**	**7.2**	**1382**	**61.2**	**421.5**	**36.9**	**2258**	**100.0**

Figure 1. Proportions of AIs by Type and Materiality Groupings (n = 2258)

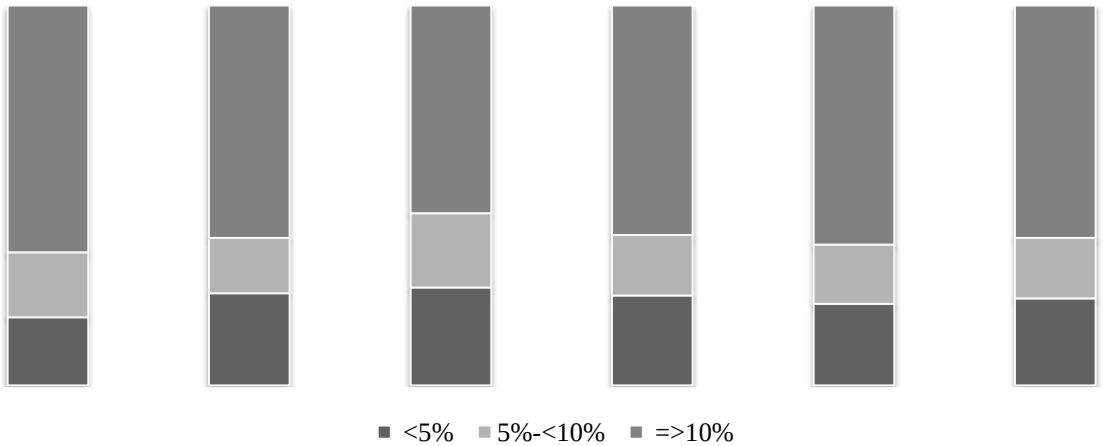


Table 2. Descriptive Statisics by AI Aggregation Grouping and Materiality Level

	<5%				5% - < 10%				=>10%				Total		
	n	% of Category	Mean	MD	*n*	% of Category	Mean	MD	*n*	% of Category	Mean	MD	*n*	Mean	MD
Aggregate Level (1)															
Provisions	26	13.9	3.0	3.1	33	17.6	7.5	7.6	128	68.4	322.6	46.0	187	222.6	23.8
Charges	102	16.8	2.6	2.9	73	12.0	7.5	7.5	431	71.1	611.2	54.0	606	436.1	29.4
Restructure	66	22.1	2.8	3.2	61	20.4	7.1	7.0	172	57.5	458.7	26.5	299	266.0	12.9
Income AIs	76	14.2	2.5	2.4	72	13.4	7.4	7.2	388	72.4	620.2	45.4	536	451.4	25.1
Aggregate Level (2)															
Total Expense AIs	79	10.6	2.8	3.1	96	12.8	7.6	7.7	573	76.6	670.9	54.0	748	515.2	33.9
Income AIs	76	14.2	2.5	2.4	72	13.4	7.4	7.2	388	72.4	620.2	45.4	536	451.4	25.1
Aggregate Level (3)															
Total AIs	134	14.8	2.4	2.3	123	13.6	7.4	7.5	650	71.7	660.1	52.6	907	474.4	28.1

Table 2 presents the descriptive statistics for each level of aggregation of AIs in each of the three materiality categories. When compared with the totals for individual AIs reported in Table 1, it can be seen that aggregating like items results in higher proportions of AIs falling into the material group. For example, 65% of individual AIs in the provision category were material (Table 1), and when the provisions are aggregated within firm-years (level 1), the proportion of aggregated provisions that were material increases to 68.4%. Nevertheless, there are still high proportions of aggregated AIs that were immaterial; notably, 22.1% of aggregated restructure AIs were immaterial and 20.4% were marginally material. Similarly, at the next level of aggregation (level 2), just under 25% of the aggregated Expense AIs and just over 25% of the aggregated Income AIs were either immaterial or marginally material. Even at the highest level of aggregation (level 3), 14.8% (134 firm-years) of the total 907 firm-years reporting AIs were immaterial and 13.6% (123) of the total 907 firm-years fell in the 'grey area' of marginally material.

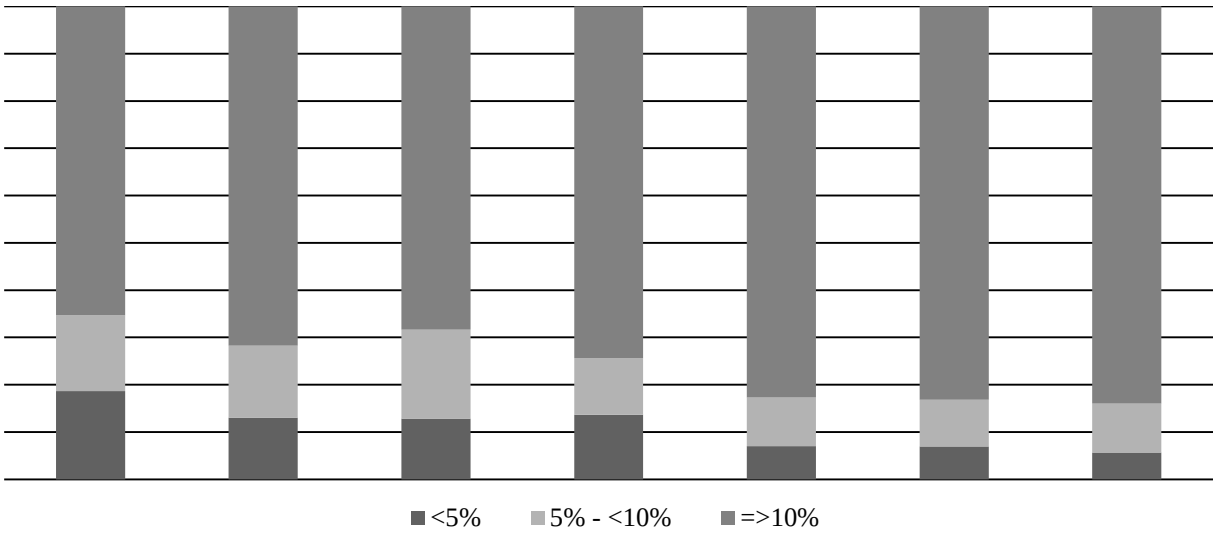
Our second research question is: Was the frequency of immaterial (<5%), marginally material (5%-<10%) and material (=>10%)abnormal items consistent over time. To address this question Table 3 presents the frequencies of AIs as a proportion of totals for aggregate level (2) on a year-by-year basis and for each materiality level; graphical presentation of the proportions are in Figures 2 and 3. Table 3 shows that in 1994 about 19% of Total Expense AIs were immaterial (<5%) declining to 5.7% in the year 2000. The highest proportion of marginally immaterial expense AIs was in 1996 at 18.8% with the lowest proportion about 10% in 1999. The year 1996 has the largest proportion of immaterial income AIs at nearly 20% and the lowest proportion is 10% in 1998. For the marginally immaterial income AIs, 1999 records the highest proportion at just over 19% (19.1) and the lowest proportion of marginally material AIs is 10.9% in 1994.

Table 3. Frequencies of Abnormal Items for Aggregate Level (2) by Sample Year

	1994		1995		1996		1997		1998		1999		2000		Total
	n	% of Year	*n*	% of Year	*n*	% of Year	*n*	% of Year	*n*	% of Year	*n*	% of Year	*n*	% of Year	*n*
Expense AIs															
<5%	14	18.7	12	13.0	13	12.9	16	13.7	11	7.1	7	6.9	6	5.7	79
5% - <10%	12	16.0	14	15.2	19	18.8	14	12.0	16	10.3	10	9.9	11	10.4	96
=>10%	49	65.3	66	71.8	69	68.3	87	74.3	129	82.7	84	83.2	89	83.9	573
Total Aggregate Level (2)	75	100	92	100	101	100	117	100	156	100	101	100	106	100	748
Income AIs															
<5%	8	12.5	13	17.8	16	19.7	11	12.8	9	10.0	11	16.2	8	10.8	76
5% - <10%	7	10.9	8	11.0	11	13.6	11	12.8	13	14.4	13	19.1	9	12.2	72
=>10%	49	76.6	52	71.2	54	66.7	64	74.4	68	75.6	44	64.7	57	77.0	388
Total Aggregate Level (2)	64	100	73	100	81	100	86	100	90	100.0	68	100	74	100	536

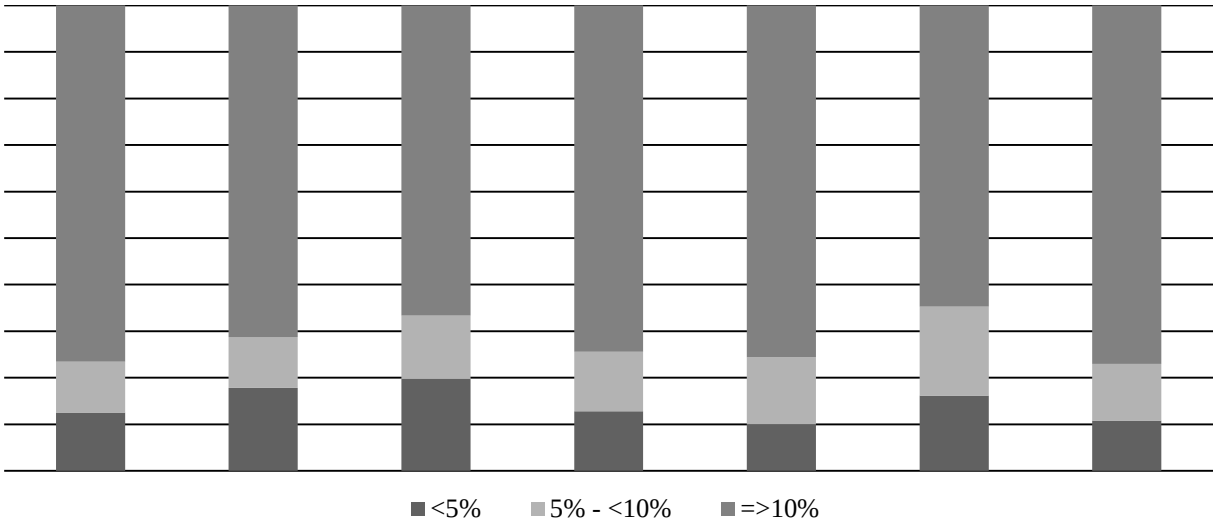
Figure 2 shows that the proportions of both immaterial and marginally material total expense AIs trended downward in the later years of the sample period. This trend suggests that the criticisms in the financial press in the late 1990s (see for example, McLean, 1999) of firms using immaterial and marginally material income-increasing abnormal items to present 'better' earnings before abnormal items number may have had some effect.

Figure 2. Proportion (%) of Total Expense AIs by Materialty Level for Aggregate Level (2) by Year



In contrast, Figure 3 shows that the proportions of immaterial and marginally material income AIs fluctuated from year-to-year, with no clear trend.

Figure 3. Proportion (%) of Income AIs by Materialty Level for Aggregate Level (2) by Year



5 Conclusion

The concept of materiality plays a key role in the disclosure of information in financial reports in that the relevance of information is affected by its materiality. Information can be material in relation to the relative size (amount) of an item, or groups of items, or its nature. Policy-makers have been grappling with providing guidance on how the materiality concept should be applied, with the objective of ensuring relevant (material) information is appropriately disclosed while avoiding disclosure of immaterial information that may confuse or mislead users. The general rule of thumb for applying materiality in practice is 5%, that is, items falling under a 5% threshold are generally considered not material (AASB 1031; Webber et al, 2013).

In this paper we have investigated how financial report preparers have applied the materiality concept at a time when separate disclosure of abnormal items

was required based only on *size*. That is, under AASB1018 that applied prior to 2001, items that met the 'size and effect' criterion were required to be separately disclosed as abnormal. Our evidence shows that large proportions of items classified as 'abnormal' were immaterial in magnitude. Whilst firms may have applied the materiality criterion relating to the *nature* of the items, doing so was contrary to the requirements of the accounting standard which made no reference to the nature of items when determining whether they should be classified as 'abnormal'.

We provide evidence that during the seven-year study period (1994 to 2000) 22.9% of abnormal items (AIs) reported in firms' annual financial reports were immaterial (<5% of operating profit before abnormal items). A further 15.2% of AIs fell into the marginally material category (between 5% and <10%), leaving only 61.2% in the clearly material category (=>10%). These findings indicate that relatively large proportions of items reported as abnormal failed the 'size and effect' criterion of AASB 1018 and accordingly were incorrectly disclosed as AIs. Our findings also show that this misclassification of items as abnormal was spread across a broad range of types of items. An implication of these findings is that users may have been misled if they relied on that information for their decision-making. The findings of this study also have implications for accounting policy makers. Both the U.K. Financial Reporting Review Panel and the European Securities and Markets Authority have expressed concern in regard to the inconsistent application of the materiality concept in the preparation of financial statements and commented that the inclusion of immaterial items may mislead users to conclude that these items are material. The U.K. Financial Reporting Review Panel suggests that a more rigorous approach to materiality may lead to more meaningful and relevant information for users and is encouraging Boards to apply a quantitative materiality threshold when preparing financial statements. The European Securities and Markets Authority has also raised the issue of whether quantitative thresholds should be mandated (EASM/2011/373). Overall, preparers and their representatives, accounting bodies, auditors, regulators and users are of the view that there is diversity in the application of materiality in financial reporting (EASM/2012/525). This study provides evidence supporting that perception.

If the EASM's purpose of considering establishing quantitative thresholds is to bring about the consistent application of the materiality concept in quantitative terms, then our evidence would suggest that qualitative considerations should not be an alternative criterion in the assessment of materiality. Our evidence suggests that qualitative considerations could circumvent mandated quantitative thresholds by disclosing immaterial amounts as material. However, applying only quantitative thresholds in assessing materiality would run counter to the IASB's principles-based standards, as mandatory quantitative thresholds absent any qualitative considerations introduce a prescriptive 'rules-based' requirement contradicting a principles-based approach. The IASB plans to start a project on materiality, the purpose being to create either general application guidance or education material. Such a project will look at how materiality is applied in practice and whether more guidance should be added to IAS 1 (IASB 2013:16).

The current debate on 'materiality on financial reporting' demonstrates that the concept of materiality and its application is and will continue to be an on-going challenge for the regulators.

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