20 February 2012

Our ref: ICAEW Rep 17/12

Your ref: ESMA/2011/373

European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

Dear Sirs

CONSIDERATIONS OF MATERIALITY IN FINANCIAL REPORTING

ICAEW is pleased to respond to your request for comments on the consultation paper *Considerations of Materiality in Financial Reporting*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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cc: Hans Hoogervorst, Chairman, IASB

ICAEW REPRESENTATION

CONSIDERATIONS OF MATERIALITY IN FINANCIAL REPORTING

Memorandum of comment submitted in February 2012 by ICAEW, in response to the European Securities and Markets Authority consultation paper *Considerations of Materiality in Financial Reporting*, published in November 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Considerations of Materiality in Financial Reporting* published by the European Securities and Markets Authority (ESMA) on 9 November 2011, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial knowledge and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

COMMENTS ON THE CONSULTATION PAPER

MAJOR POINTS

5. It is not clear to us what problems the consultation paper seeks to address. Although it refers at the outset to 'the apparent differing views regarding the practical application of the concept of materiality amongst preparers, auditors, possibly users of the financial reports and, in some instances, accounting enforcers', it does not say what these differing views are.

6. The consultation paper quotes the definition of materiality given by the International Accounting Standards Board (IASB) in IAS 1, *Presentation of Financial Statements*. In our view it is essential that this should be the basis of any shared understanding of materiality. To allow any deviation from this would only encourage an ever-widening expectation gap on the part of users of financial reporting and confusion among users and regulators. If there is a problem in achieving a common understanding of what materiality means, then it should be dealt with by the IASB. International Financial Reporting Standards (IFRS) need to be applied around the world, and it would be unhelpful to all interested parties to have distinctive EU guidance on how IFRS are interpreted. ESMA is no doubt still establishing the appropriate boundaries for its responsibilities in relation to those of other European and global public bodies. We believe that EFRAG (the European Financial Reporting Advisory Group) rather than ESMA is probably the appropriate body to examine materiality in financial reporting from an EU perspective. However, ESMA and national enforcers may well in the course of their work discover practical problems in interpreting IFRS, and it will always be useful for the IASB to be made aware of these issues.

7. The subject of materiality in relation to financial reporting disclosures is in fact likely to be picked up in the disclosure framework project that we hope and expect the IASB will put on its agenda. This may deal with some of the more significant questions in this area and should also pick up the accounting policy and key judgement issues relating to materiality. It would no doubt be very helpful to the IASB if ESMA could share with it the responses that it receives to the current consultation. From an EU perspective, EFRAG is already looking at the question of

a financial reporting disclosure framework, although its project is still at an early stage, but again we would expect the results of the project to be delivered to the IASB for its consideration.

8. We agree that it would be helpful for references to materiality in auditing and accounting standards to be aligned. The IASB and the International Auditing and Assurance Standards Board (IAASB), rather than ESMA, are the appropriate bodies to do this. They are already working together more closely and this would be a good issue for them to address jointly. The IAASB also already has a project underway on *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*, which includes consideration of the concept of materiality. This should provide a useful basis for any joint work on the issue with the IASB.

SPECIFIC QUESTIONS

Question 1

Do you think that the concept of materiality is clearly understood and applied in practice by preparers, auditors, users and accounting enforcers or do you feel more clarification is required?

9. So far as we are aware, the concept of materiality is reasonably well understood by all interested parties, although there may be different nuances in its interpretation across the EU that reflect different countries' cultures, institutions and past financial reporting practices. If there are differences of view as to what materiality means, then – as stated above – we believe that the IASB is the right body to deal with the issue. If ESMA has gathered information on different views as to the meaning of materiality, it would be helpful for it to share this data – as well as comments submitted during this consultation – with the IASB.

10. In relation to users, we would point out that *The Conceptual Framework for Financial Reporting 2010* states that: 'Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently' (QC32). We would expect such users to have a good understanding of the materiality concept, though it is of course likely that less sophisticated users may not understand it. For such users there may well be a great deal that they do not understand about financial reporting.

11. We assume that the differences of view on materiality that ESMA refers to are at a general level. Clearly, as judgements of materiality are subjective, it is inevitable that different parties will often have differing views on the application of materiality in particular cases. The existence of such differences in particular cases does not imply a difference of view on what materiality means in general terms.

12. The main concern regarding materiality in the UK at the moment is that the concept may not be applied often enough to exclude immaterial items that clutter up the accounts. It would be useful to know how far this concern is shared by accounting enforcers across the EU. ICAEW has some guidance in issue on materiality in the form of Technical Release 03/08, *Guidance on Materiality in Financial Reporting by UK Entities*. This was published in 2008, although it updated much older guidance and, in spite of the fact that some of the references in this guidance statement are now out of date, we understand that it is still regarded as useful by UK preparers and auditors. Nevertheless, it is not held out as interpreting IFRS and is certainly not mandatory or a template for regulatory action, which guidance from a regulator inevitably would be. We are also aware that some of those who advocate 'cutting clutter' from financial statements disagree with the overall thrust of the ICAEW guidance – an indication of the different views the subject can stimulate in different commentators at different times. We are sending ESMA and the IASB copies of the statement separately in case it is of use as a point of reference, but as noted above, we would not advocate any attempt to issue authoritative guidance by anyone other than the IASB.

Question 2

Do you think ESMA should issue guidance in this regard?

13. For the reasons explained at paragraphs 6-7 above, we do not think that ESMA should issue guidance on materiality in financial reporting. If there is an issue here that needs to be dealt with – and it is not clear from the consultation document that there is – then the IASB is the right body to deal with it.

Question 3

In your opinion, are ‘economic decisions made by users’ the same as users making ‘decisions about providing resources to the entity’? Please explain your rationale and if possible provide examples.

14. ‘Economic decisions made by users’ is a term that covers a wide variety of decisions, such as: whether to buy, sell or hold shares; whether to provide fresh resources in the form of equity or a loan; whether to take action in relation to the appointment of directors or their remuneration; whether to intervene in the strategy of the business. Decisions about providing resources to the entity are therefore only a sub-group of economic decisions made by users. We do not agree with the IASB (paragraph OB2 of *The Conceptual Framework for Financial Reporting 2010*) that the objective of financial reporting relates only to ‘providing resources to the entity’ and we would have preferred a broader definition (see ICAEW REP 111/08, *An Improved Conceptual Framework for Financial Reporting: Chapters 1 & 2*). However, we are not aware that these differences in wording give rise to differences in practice in applying the concept of materiality.

Question 4

Is it your understanding that the primary user constituency of general purpose financial reports as defined by the IASB in paragraph 13 includes those users as outlined in paragraph 16 above? Please explain your rationale and if possible provide further examples.

15. Paragraph 16 of the consultation document lists types of decision, not users. We suspect that the reference is intended to be to paragraph 15, which does list different users, although this paragraph also makes it clear that some of the users it lists are not primary users as defined by the IASB.

16. It is evident from paragraphs OB2 and OB5 of *The Conceptual Framework for Financial Reporting 2010* that the IASB regards ‘existing and potential investors, lenders and other creditors’ who are unable to require information to be reported directly to them as the primary users of financial reporting. We agree with the IASB on this point. Paragraph 15 of the consultation document lists ‘existing and potential investors, employees, lenders, suppliers, customers, regulators and other Government agencies and the public’ as ‘stakeholders with an interest in an entity’s financial reports’. We set out below our analysis of whether these groups should be regarded as primary users:

- Existing and potential investors and lenders are primary users within the IASB’s definition, as long as they are unable to require information to be reported directly to them.

- Employees, suppliers and customers are primary users within the IASB’s definition only to the extent that they are creditors and, again, as long as they are unable to require information to be reported directly to them.

- Those who advise investors or act on their behalf (eg, sell-side analysts and credit rating agencies) do not strictly come within the category of primary users as defined by the IASB, but we notice that in practice they are often treated as important users – in consultation exercises, for example. Clearly there is some logic in this as they are, to a greater or lesser degree, acting with primary users' interests in mind and, unlike many of those who meet the definition of primary users, they actually use financial reporting information.

- Certain regulators and other government agencies could potentially be regarded as primary users within the IASB's definition to the extent that their role is to act on behalf of investors, lenders or other creditors (analogously, perhaps, with those such as sell-side analysts and credit-rating agencies) However, such regulators and agencies are normally in a position to require information to be reported directly to them and they are not in practice, therefore, regarded as primary users of financial reporting.

- Otherwise, regulators and other government agencies and the public are not primary users within the IASB's definition.

Users that are not primary users within the IASB's definition may well, of course, be secondary users.

Question 5a

Do you agree that the IASB's use of the word 'could' as opposed to, for example, 'would' implies a lower materiality threshold? Please explain your rationale in this regard.

17. We agree that '**could**' logically implies a lower materiality threshold than '**would**'. It is generally easier to argue persuasively that an omission or misstatement could affect a user's decision than to argue that it would, as 'would' implies a greater degree of certainty. For example, one might argue persuasively that in certain circumstances a 50% adjustment to the reported profit both could and would affect users' decisions. But while one might argue that a 5% adjustment in the same circumstances could affect users' decisions, it would be more difficult to be confident that it would. It follows that 'could' logically implies a lower materiality threshold.

18. We suggest that if ESMA wishes to understand better why the IASB uses 'could' at paragraph QC11 of *The Conceptual Framework for Financial Reporting 2010* it would probably be useful to discuss the matter with the IASB.

Question 5b

In your opinion, could the inclusion of the expression 'reasonably be expected to' as per the Auditing Standards, lead to a different assessment of materiality for auditing purposes than that used for financial reporting purposes? Have you seen any instances of this in practice?

19. As neither preparers nor auditors usually know with certainty how users will react to potential omissions or misstatements, they are compelled to rely instead on judgements as to how users might reasonably be expected to react. For this reason, in our view the difference in wording does not lead to any differences in practice as both preparers and auditors when assessing materiality have to make judgements based on reasonable expectations. However, we agree that it would be helpful for the wording in auditing and accounting standards to be aligned in this respect, preferably using the wording in auditing standards.

Question 6a

Do you agree that the quantitative analysis of the materiality of an item should not be determined solely by a simple quantitative comparison to primary statement totals such as profit for the period or statement of financial position totals and that the individual line item in the primary statement to which the item is included should be assessed when determining the materiality of the item in question? Please explain your rationale in this regard.

20. We agree with the point made in the question, but would express it differently. In assessing materiality, different qualitative considerations apply to different items and these in turn affect

how the quantitative aspects are regarded. For example, the qualitative significance of related party transactions is such that quantitative considerations are likely to weigh little in deciding what should be disclosed. Also, a single line item may need to be considered from different points of view: in its own right, as part of a sub-group (eg, net current assets), and from the perspective of the financial statements as a whole. Each point of view is likely to imply different quantitative criteria in considering the potential impact of omissions or misstatements, which in turn need to be considered in the context of whether they would mean that the financial statements as a whole fail to give a true and fair view. The key point is that in making materiality judgements both qualitative and quantitative considerations need to be taken into account and these affect different items in different ways. It is not purely a question of applying different quantitative thresholds.

Question 6b

Do you agree that each of the examples provided in paragraph [22] a-e above constitute instances where the quantitative materiality threshold may be lower? Are there other instances which might be cited as examples? Please explain your rationale.

21. We agree that, because of qualitative considerations affecting the examples provided, quantitative thresholds for these items might well be lower. Again, the key point is that both qualitative and quantitative considerations need to be taken into account and these affect different items in different ways.

Question 7

Do you agree that preparers of financial reports should assess the impact of all misstatements and omissions, including those that arose in earlier periods and are of continued applicability in the current period, in determining materiality decisions? Please explain your views in this regard.

22. We agree with the point made in the question, and as far as we are aware this is what happens in practice. If some of the potential issues mentioned were left out of account, there is a risk that users could be misled.

Question 8

Do you agree that preparers of financial reports should assess the impact of all misstatements and omissions as referred to in paragraphs [24] to [27] above in determining materiality? Please explain your views in this regard and provide practical examples, if applicable.

23. Again, we agree with the point made in the question, and for the same reason as that given in response to Question 7. We do not see how in substance this question differs from Question 7. In relation to both questions, we would again make the point that both qualitative and quantitative considerations need to be taken into account.

Question 9

a) Do you believe that an accounting policy disclosing the materiality judgments exercised by preparers should be provided in the financial statements?

b) If so, please provide an outline of the nature of such disclosures.

c) In either case, please explain your rationale in this regard.

24. We do not believe that an accounting policy disclosing the materiality judgments exercised by preparers should be provided in the financial statements. There seem to be broadly three options for such a disclosure. It could list the matters not disclosed on grounds of immateriality, which would defeat the object of not disclosing them. Or it could be a general statement of the preparer's approach to materiality judgements, which would almost inevitably be boilerplate. The third option, a full disclosure of all these considerations, would be highly complex. This is because, as we have explained, different quantitative and qualitative considerations apply to

different items in the accounts and even to the same item viewed from different perspectives. As the consultation paper itself points out, paragraph 122 of IAS 1, *Presentation of Financial Statements*, already requires disclosure of key judgements made in preparing the accounts.

Question10

Do you agree that omitting required notes giving additional information about a material line item in the financial statements constitutes a misstatement? Please explain your rationale in this regard.

25. Such an omission might or might not constitute a material misstatement. It depends on the nature of the additional information involved, including its quantitative aspects.

Question 11

Do you believe that in determining the materiality applying to notes which do not relate directly to financial statement items but are nonetheless of significance for the overall assessment of the financial statements of a reporting entity:

d) the same considerations apply as in determining the materiality applying to items which relate directly to financial statement items; or

e) different considerations apply; and

f) if different considerations apply, please outline those different considerations.

26. In determining materiality, the same overall considerations apply to all items in the financial statements – ie, their potential effect on users' decisions. However, as we have explained, every particular item needs to be considered in the context of its own features – qualitative and quantitative. Whether or not a note relates directly to a financial statement item does not in itself mean that different considerations would apply in determining materiality.

Question 12

In your opinion, how would the materiality assessment as it applies to interim financial reports differ from the materiality assessment as it applies to annual financial reports?

27. In general, the same principles apply in considering materiality in interim reports as in annual reports. However, the assessment of materiality in relation to interim reports can be more complex as the information they provide needs to be considered in relation to both the previous full-year report and the previous interim report for the comparable period, as users will consider both in looking for trends. This is likely to be particularly important in seasonal businesses, for which interim results contribute disproportionately (in either direction) to the annual result. Also, materiality questions would of course be considered in the context of the interim figures presented, rather than in the context of the expected full-year figures of which they will eventually form a part.

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