EFRAG

European Financial Reporting Advisory Group

DRAFT COMMENT LETTER
Comments should be submitted by 27 February 2012 to
Commentletter@efrag.org

Steven Maijoor
Chairman
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

27 January 2012

Dear Mr Maijoor,

ESMA Consultation Paper – *Considerations of materiality in financial reporting*

On behalf of the European Reporting Advisory Group (EFRAG), I am writing to comment on the ESMA consultation paper, *Considerations of materiality in financial reporting* issued on 9 November 2011. This letter is submitted in order to contribute to ESMA's due process in a timely manner.

EFRAG welcomes the initiative taken by ESMA to stimulate debate on the concept of materiality and its application. However, should the need for further clarification emerge from this debate, EFRAG thinks that it is the role of the IASB to provide it. In our view, that does not diminish but supports the critical role ESMA has to ensure consistent application across the European Union of IFRS as defined globally.

EFRAG notes that under the revised Framework 'materiality' is an aspect of relevance, underscoring the need for the financial statements to provide information that is useful to users for economic decision-making. EFRAG believes that the materiality judgements should not be made in isolation, and that it is important that surrounding circumstances always be taken into account. Accordingly, whilst quantitative thresholds are helpful in highlighting the areas that require attention, they should never be applied mechanically without considering relevant qualitative factors.

The application of materiality to disclosures requires a greater level of judgement. Hence, the assessment of whether disclosures requirements are met should be made on the basis of the aggregate information, i.e. for example whether users are provided with relevant information to assist them in understanding a particular risk exposure. As a result, auditors or enforcers should not, in our view, require additional disclosures if they cannot justify how the additional information could influence the users' economic decisions. It is our view that the failure to appropriately apply materiality in practice, is having a detrimental effect on the quality of information reported in the notes to financial statements. That problem has been widely reported on in recent studies, both in the EU and other jurisdictions. It was because of those issues that EFRAG and its partners commenced a project to consider developing a set of principles to guide disclosure requirements in IFRS. Materiality is one of the key principles being considered as part of that project. We intend later this year, with our partners the Autorité des Normes Comptables and the UK Accounting Standards Board, to issue a discussion paper about possible ways in which the IASB could ensure that the concept of materiality is actually applied. EFRAG is particularly grateful for the assistance ESMA is providing to that project.

Our detailed responses to the questions in the consultation paper are set out in the appendix to this letter.

If you would like to discuss our comments further, please do not hesitate to contact Mario Abela or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

Appendix

Notes to constituents

1 *The objective of financial statements is to provide relevant information that enable users to make economic decisions about a reporting entity. To be useful, such statements must present fairly the financial position, performance and cash flows of the entity. Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report*[1]*.*

2 *The application of the concept of materiality is of critical importance in the context of the preparation of financial statements. It impacts on many decisions such as how an entity should recognise, measure, and disclose specific transactions and other events in the financial statements, whether misstatements require correction and whether assets and liabilities or items of income or expense should be separately presented.*

3 *The concept of materiality is specifically relevant to EFRAG's proactive project on a Framework for the notes to the financial statements; there seems to be differing views regarding the practical application of the concept of materiality amongst preparers, auditors, possibly users of the financial reports and, in some instances, regulators in regard to disclosures. Some parties are concerned with what they consider "disclosure overload"*[2] *while others point out that existing requirements are not yet satisfying the needs of users. The objective of ESMA's paper is to seek views on the concept of materiality in an effort to contribute to the consistent application of this important concept in financial reporting.*

4 *The term 'material' is defined as follows*[3]*: 'Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the light of the specific facts and circumstances of the entity and the users of its accounts. The size or nature of the item, or a combination of both, could be the determining factor.'*

1 QC11 of The Conceptual Framework for Financial Reporting 2010.

2 ICAS & NZICA (2011) 'Losing the excess baggage' from ICAS & NZICA, and 'UK FRC (2011) 'Cutting the clutter: Combating clutter in annual reports'.

3 IAS 1 – Presentation of Financial Statements, paragraph 7 and IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors, paragraph 5.

Question 1

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

EFRAG's response

EFRAG acknowledges the fact that there are some practical issues arising from different approaches to materiality by different stakeholders. This is to be expected because the concept of materiality requires exercising professional judgement at the level of the reporting entity. Those judgements cannot be properly made if the concept of materiality is defined as a set of prescriptive rules that are applied at the lowest level of granularity. Therefore, EFRAG believes that some effort is needed to reach a better common understanding of how the concept of materiality should be applied, reviewed and enforced.

5 Difficulties identified in practice should not lead to developing detailed, prescriptive application guidance. To the contrary, materiality is, by definition, a dynamic concept that involves judgement, and as the specific circumstances of a reporting entity are likely to differ from one entity to the next, different reporting outcomes do not necessarily imply that there is a divergence in how materiality is applied.

6 A number of recently published reports argue that there is a behavioural issue with the application of the materiality concept to the notes to financial statements. Strictly following disclosure requirements at the lowest level of granularity may lead to cluttering the notes with immaterial information, particularly if the sole objective is to safely pass 'check-list' type tests, in the review and enforcement of financial reports.

7 EFRAG believes that, in regard to disclosures, the quality and relevance of information is enhanced not only by assuring that all material information is given, but also by excluding immaterial items, as these do not affect the users' economic decisions. Rather, the provision of immaterial information hinders the usefulness of the disclosures, as valuable information is difficult to identify amongst irrelevant data. We believe that attention should be given to the application of the materiality concept to disclosures, and we intend to contribute to this discussion in the context of our proactive project on developing a disclosure framework, which we are developing with our partners, the Autorité des Normes Comptables and the UK Accounting Standards Board.

Question 2

Do you think ESMA should issue guidance in this regard?

EFRAG's response

EFRAG believes that it is the IASB's role to promote a debate on the definition and application of materiality. If the need for further clarification emerges from that debate, it is the IASB that is best placed to provide it.

8 EFRAG believes that it is the IASB's role to drive the debate about materiality and provide further clarification on the concept and its application. If it emerges from such a debate that clarification is needed, different stakeholders such as preparers, users, auditors and regulators can provide useful input in order to reach a better common understanding.

9 EFRAG believes that it would not be useful for regulators to issue guidance on the application of materiality as it would be contrary to the sound application of the concept of materiality. This would not provide consistent application, but merely standardise practice hiding differences in economic reality. Furthermore, creating conditions for consistency is valid at global level. Local and regional practice should not be encouraged. We therefore believe that ESMA should not issue guidance and should seek to discourage national regulators from doing so.

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.

Notes to constituents

10 *The Framework notes that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors (who are termed the 'primary users' of financial statements) in making decisions about providing resources to the entity.*

11 *The definition of materiality in IAS 1 paragraph 7 (noted above) puts emphasis on whether an item 'could influence the economic decisions that users make'. The stated objective of general purpose financial reporting in the Framework is to provide useful information to aid user decision-making about 'providing resources to the entity'. Being able to assess the stewardship or accountability of management is integral to any understanding of materiality, and will help users make economic decisions.*

EFRAG's response

EFRAG believes the expressions are, in substance, conveying identical messages and therefore they do not warrant separate definitions.

12 EFRAG does not see a real difference between the two expressions. Every party that decides to enter into a transaction with an entity, also decides to provide resources to that entity. This is true for lenders and investors, as well as for suppliers, creditors and employees. As a consequence EFRAG does not believe that the concept of materiality can be described in different ways as suggested in the different wording identified in the question.

13 Understanding IFRS and their requirements relies on having IFRS translated into numerous languages, each having different levels of nuances and subtleties. We firmly believe that no detailed exegesis of the standards should be carried out in the hope to identify intended and significant differences. The choice of different words can result from various texts being written and reviewed by different authors at different times, although the fundamental concepts and bases do not vary.

14 Moreover, EFRAG's considers that there is merit in encouraging the IASB to avoid confusion by make sure that consistent wording is used throughout the IFRS literature.

Question 4

Is it your understanding that the primary user constituency of general purpose financial reports as defined by the IASB in paragraph 13[4] includes those users as outlined in paragraph 16 above[5]? Please explain your rationale and if possible provide further examples.

Notes to constituents

15 *Both paragraphs (13 and 16) of the ESMA consultation paper describe the same groups of users.*

1. *<u>Paragraph 13</u>: 'Since the assessment of materiality requires evaluation of whether particular information could influence users' decisions, an understanding of the type of users of an entity's financial statements and the kind of decisions they make is necessary. The Framework notes that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors (who are termed the 'primary users' of financial statements) in making decisions about providing resources to the entity. The Framework also acknowledges that other parties, such as regulators and members of the public may also find general purpose financial reports useful. However, it is also noted that the Framework states that financial reports are not primarily directed to those other parties.'*

2. *<u>Paragraph 16</u>: 'The types of decisions that primary users make and the kind of information that may be relevant to those decisions also require consideration in the context of the evaluation of an omission or misstatement. 'Relevant information' is that which is capable of making a difference in the decisions made by users. For example, financial statements could normally be expected to provide information that is relevant for primary users in decisions regarding:*

    a. *whether to decide to buy, hold or sell of an entity's equity and debt instruments (existing and potential investors);*

    b. *whether to provide and settle loans and other forms of credit (existing and potential lenders and other creditors);*

    c. *the ability of the entity to provide remuneration and retirement benefits (present and past employees);*

    d. *whether amounts owed are likely to be paid and whether to continue to supply goods and/or services to the entity (existing and potential creditors and present employees); and*

[4] The paragraph number refers to the ESMA consultation paper.
[5] The paragraph number refers to the ESMA consultation paper.

e. the entity's compliance with certain regulatory requirements (existing and potential investors, lenders and other creditors).'

EFRAG's response

EFRAG agrees that both paragraphs (13 and 16) of the ESMA consultation paper describe the same groups of users.

Question 5

(a) 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.

(b) 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?

Notes to constituents

16 *In paragraph 19 of the Discussion Paper, ESMA notes that the assessment of materiality involves consideration of whether an omission or misstatement '… **could** … influence the economic decisions that users make …' The information does not have to change a decision, but rather it must have the capacity to influence it. For example, having considered additional relevant information, a primary user may not alter a decision, although in different circumstances, such information could have changed the decision. Moreover, a particular piece of information may lend further support to information or trends already evident in the financial statements and thus reinforce the primary user's decision. In light of the foregoing, in ESMA's opinion, IASB's use of the word 'could' as opposed to, for example, '**would**' implies a lower materiality threshold. It is also noted that the auditing standards, when referring to misstatements and omissions, uses the expression 'could **reasonably be expected to** influence the economic decisions of users' which could also lead to a different assessment of materiality.*

EFRAG's response

EFRAG believes that the distinction between 'could', *'could reasonably be expected to' and 'would'* is one of semantics. We do not see that any practical implication should flow from making this distinction.

IFRS is a principle-based set of standards, the understanding of which cannot depend of subtle differences in wording. Refer to our statement in response to question 3.

Question 6[6]

(a) 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.

(b) Do you agree that each of the examples provided in paragraph 22 a – e above[7] **constitute instances where the materiality threshold may be lower? Are there other instances which might be cited as examples? Please explain your rationale.**

Notes to constituents

17 *The IASB definition of the term 'material' identifies the attributes of both nature and size, and specifies that items should be judged in the surrounding circumstances of their omission or misstatement. In other words, both quantitative and qualitative factors are relevant to all materiality decisions.*

1. *<u>Paragraph 22</u>: 'The nature of, and the circumstances surrounding, an item will vary and each entity must make an assessment according to its own particular circumstances and financial statements. Examples of common transactions and outcomes where materiality judgements are usually particularly sensitive, and thus where the adjudged materiality threshold may be lower, include, amongst others:*

   a. *breaches of legal and/or regulatory requirements;*

   b. *transactions with related parties, including key management personnel's compensation;*

   c. *an unusual or non-recurring transaction(s)/balance(s);*

   d. *an error that results in a reversal of a trend - for example, a loss being turned into a profit or vice versa; and*

[6] EFRAG has grouped together its response to questions 6, 7 and 8.

[7] The paragraph number refers to ESMA's consultation paper.

e. an error that impacts on ratios or other metrics used to evaluate, for example, compliance with debt covenants.'

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.

Notes to constituents

18 *Paragraphs 24 to 27 of the ESMA consultation paper:*

24. Uncorrected immaterial errors: During the periodic financial reporting process, there is the potential for using materiality in order to achieve a particular presentation of an entity's financial position, financial performance or cash flows by intentionally leaving errors uncorrected on the grounds that they are not material. IFRS does not permit such departures to be left uncorrected, if they are used to achieve a particular presentation, even where they have been assessed by the entity as immaterial.

25. Aggregation of individually immaterial misstatements or omissions: In the assessment of whether the financial statements are misstated, consideration should be given not only to individual departures but also to their aggregation. A number of departures which individually are considered immaterial when aggregated may mean that the financial statements are materially misstated.

26. Netting of misstatements: The set-off of compensating error amounts does not necessarily render material misstatements immaterial, particularly where such items do not appear in the same line item or subtotal amount, or where they, on their own, would relate to transactions meriting separate disclosure.

27. Effects of accumulated misstatements: Accumulated misstatements have to be assessed based on their impact on each financial statement period and the related financial statement disclosure. An individual misstatement which was immaterial in the reporting period in which it occurred could become material when considered with other similar misstatements in other reporting periods.

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[8] above in determining materiality? Please explain your views in this regard and provide practical examples, if applicable.

[8] Question 8 should refer to paragraphs 24 to 27, not to paragraphs 23 to 26 (see ESMA document).

EFRAG's response to questions 6, 7 and 8.

EFRAG believes that the quantitative and qualitative aspects of materiality cannot be meaningfully separated, and that one should always look at the overall facts and circumstances. Furthermore, EFRAG believes one should move away from establishing lists to avoid a mechanical compliance approach (the so-called 'tickbox' mentality).

19 As mentioned above, EFRAG believes that, should the need for further clarification emerge from the debate, it is the IASB's role and not ESMA's to provide it.

20 Notwithstanding that it for the IASB to take the lead on this matter, EFRAG agrees that materiality cannot be expressed merely as a percentage of various totals in primary financial statements such as profit for the period or total assets. We believe that assessing materiality requires considering various quantitative and qualitative aspects. Therefore, there will be cases where the size of the amounts involved should be given less weight in the assessment. However, EFRAG believes drawing up lists as in paragraph 22 of the ESMA consultation paper is unhelpful, as such lists could lead to mechanical compliance, and a failure to properly exercise professional judgement.

21 EFRAG agrees that materiality should not be assessed only at the level of the single misstatements and omissions; entities should also look at the individual instances of immaterial items and decide, whether in aggregate, they become material and warrant specific disclosures.

Question 9

(a) Do you believe that an accounting policy disclosing the materiality judgements 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.

Notes to constituents

22 *An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. In this context a view could be taken that preparers of financial reports should carefully consider making disclosures regarding materiality judgements exercised in preparing financial reports with a view to providing the primary users with information that is relevant to the primary users' understanding of those financial reports.*

23 *When an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the specific IFRS. However, these policies need not be applied if the effect is immaterial.*

24 *Primary users need to know which accounting policy choices have been applied in preparing the financial statements in order to be able to assist their decision making. Disclosures provided in accounting policies should be relevant to the entity and not boilerplate quotations from the accounting standard in question.*

EFRAG's response

EFRAG does not believe that a specific accounting policy, disclosing the materiality judgements exercised by preparers, should be provided in the financial statements.

25 In EFRAG's view it may be difficult for an entity to fully articulate an accounting policy about its application of materiality. As stated above, applying the materiality concept requires the exercise of judgement, while considering specific facts and circumstances around specific items. There is a risk that any description that is provided is generic and boilerplate and fails to convey any relevant information to users of the financial statements.

26 EFRAG also notes that, in IAS 1, there is already a general requirement to provide information about judgements that the management has made in the process of applying the entity's accounting policies.

27 Additionally, such a disclosure may prove to be prejudicial to the entity. The selection of any quantitative threshold could be challenged by users and regulators. Disclosing that misstatements lower than x% are considered immaterial may lead users to believe that the entity has omitted to correct mistakes up to that limit, although this may not be the case.

Question 10[9]

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.

Notes to constituents

28 *An item may be sufficiently material to warrant disclosure on the face of a primary statement or alternatively may be disclosed by way of note.*

29 *An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance (IAS 1, paragraph 85).*

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:

[9] EFRAG has grouped together its response to questions 10 and 11.

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

(b) different considerations apply; and

(c) if different considerations apply, please outline those different considerations.

Notes to constituents

30 *Examples of supplementary information beyond that included in the primary statements include disclosures about:*

a. judgements and reasons. These include all disclosures of judgements by management in the process of preparing the financial statements. Examples include, by exception, disclosure of material uncertainties in relation to the going concern basis of accounting;

b. assumptions, models, and inputs. These include disclosures of information relevant to the measurement of items in the financial statements, such as possible ranges of values, discount rates, effective interest rates and growth rates. This information is relevant to primary users because it explains how the entity subjectively determined the amount reported in the financial statements;

c. sensitivity analysis disclosures. These are disclosures to enable primary users to understand the underlying measurement variability of an item in the financial statements. An example is value at risk disclosures or other types of sensitivity analyses; and

d. disclosure of the fair value of an amount recorded in the balance sheet using another measurement basis, such as historical cost or amortized cost. An example is the requirement to disclose the fair value of reclassified financial assets.

31 *A number of notes do not relate directly to financial statement items but are nonetheless of significance for the overall assessment of the financial performance and position of a reporting entity. One example is the risk disclosures required to be provided in the financial statements, including disclosures of the way in which the entity manages its risks.*

32 *Omission of such material risk notes deprives primary users of material information about the undertaking and thus potentially impairs their understanding of the financial statements.*

EFRAG's response to questions 10 and 11

EFRAG believes that entities should apply judgement to assess, whether individual required disclosures are material or not, independently of the importance of the related line item in the primary financial statements.

33 Users need to have more detailed information about material line items in the primary financial statements. However, entities should not use disclosure requirements in accounting standards as a checklist. The information should only be provided in the notes if it is deemed material. EFRAG believes this is line with the recent IASB thinking, which is to set disclosure objectives in each standard and to require entities to determine which requirements should be complied with to achieve those objectives.

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?

Notes to constituents

34 *In accordance with paragraph 23 of IAS 34 the materiality assessment for interim financial reporting purposes shall be assessed in relation to the interim period financial data.*

35 *While judgement is always required in assessing materiality, IAS 34 bases the recognition and disclosure decision on data for the interim period by itself for reasons of understandability of the interim figures. Thus, for example, unusual items, changes in accounting policies or estimates, and errors are recognised and disclosed on the basis of materiality in relation to interim period data to avoid misleading inferences that might result from non-disclosure. The overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding changes in an entity's financial position and performance during the interim period.*

36 *With regard to disclosures, paragraph 16A of IAS 34 specifies certain minimum information, if material, to be included in the explanatory notes to the condensed financial statements. In addition to disclosing this minimum information, entities are also required to include disclosures concerning any events or transactions that are significant to an understanding of the changes in financial position and performance of the entity since the last annual reporting date.*

EFRAG's response

EFRAG believes that the concept of materiality should not be different with regard to interim financial statements.

37 EFRAG believes that the same concept of materiality applies to interim and annual financial statements. However, the assessment of materiality in the interim financial statements could lead to a different outcome. This point is made in paragraph 25 of IAS 34 which states that "while judgement is always required in assessing materiality, this Standard bases the recognition and disclosure decision on data for the interim period by itself for the reasons of understandability of the interim figures..." Accordingly, EFRAG believes that it is the same judgement process, but it is being applied to an interim rather annual period and so the priority is to consider the needs of users in understanding the financial results for that interim period.