

**Ms Françoise Flores**  
**European Financial Reporting**  
**Advisory Group (EFRAG)**  
**35 Square de Meeûs**  
**1000 Brussels**  
**Belgium**

**Ref: Exposure Draft IFRS Practice Statement: Application of materiality to Financial Statements**

Dear Ms Flores,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's due process regarding the IASB's Exposure Draft of IFRS Practice Statement (draft Practice Statement) *Application of Materiality to Financial Statements*. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

ESMA highly welcomes issuance of guidance on the application of materiality to IFRS financial statements. Following the ESMA Consultation Paper *Considerations of Materiality in Financial Reporting*, ESMA has requested the IASB to provide additional guidance to ensure consistent application of materiality in IFRS financial statements.

Like EFRAG, ESMA accepts the IASB arguments that in certain jurisdictions mandatory guidance on materiality could conflict with national legal requirements. Consequently, ESMA concurs that the guidance is provided in a non-mandatory form. Nevertheless, unlike EFRAG, ESMA has concerns that by issuing this guidance in the form of a Practice Statement IASB would de-emphasise the nature of the guidance and thus limit its visibility to constituents. Consequently, ESMA considers that the guidance should take the form of an Implementation Guidance to IAS 1 *Presentation of Financial Statements*.

ESMA welcomes the reference to both 'individual' and 'collective' assessment of whether information is material or immaterial. In particular, ESMA supports the conclusion that even if information is not judged to be material on its own, it might be material when considered together with other information. ESMA equally welcomes the guidance on both quantitative and qualitative assessments of materiality and in particular the application to disclosures, as this is an area where qualitative aspects of materiality play a more significant role.

Like EFRAG, ESMA considers that the examples in the draft Practice Statement on the application of materiality are helpful to make the guidance more practical and useful, as they illustrate the way judgement on materiality should be exercised and focus on those areas where judgement is most difficult to exercise. ESMA particularly welcomes the examples illustrating whether to include or leave out information as a result of assessment of materiality. In the appendix to this letter, ESMA provides specific comments on some of the examples and requests additional ones.

Finally, like EFRAG, ESMA believes that this draft Practice Statement is only a first step to improve the understanding and application of the principle of materiality in the IFRS financial statements. As such, we encourage the IASB to analyse whether additional disclosures on the judgments related to materiality and on the result of those judgements could provide useful information to users of financial statements. Therefore, ESMA welcomes the fact that further work in this area will be undertaken by the IASB within the *Principles of Disclosure* Project. In this context, the guidance included in the draft Practice Statement would be useful without waiting for the completion of the IASB's Principles of Disclosure Project.

Our detailed comments on the ED are set out in the Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S/M'.

Steven Maijoor

## Appendix I – ESMA’s detailed answers to the questions in the ED

### Question 1 – Form of the guidance

*A Practice Statement is not a Standard. The IASB’s reasoning for issuing guidance on applying the concept of materiality in the financial statements in the form of a non-mandatory Practice Statement is set out in paragraphs BC10-BC15.*

*(a) Do you think that the guidance should be issued as non-mandatory guidance? Why or why not?*

*(b) Do you think that a Practice Statement is the appropriate form for non-mandatory guidance on applying the concept of materiality? Why or why not? If not, what alternative(s) do you propose and why?*

1. ESMA highly welcomes the issuance of guidance on application of materiality to IFRS Financial Statements. Following the ESMA Consultation Paper *Considerations of Materiality in Financial Reporting*,<sup>1</sup> ESMA has requested<sup>2</sup> the IASB to provide additional guidance in order to contribute to consistent application of the materiality concept in IFRS financial statements.
2. ESMA accepts the IASB arguments that in certain jurisdictions a mandatory guidance on materiality could conflict with national legal requirements. Consequently, ESMA agrees with the non-mandatory status of the guidance on applying the concept of materiality to financial statements. However, ESMA does not believe that a Practice Statement is the appropriate form for this non-mandatory guidance. ESMA considers that the guidance on applying the concept of materiality should take the form of an Implementation Guidance to IAS 1.
3. Contrary to conclusion in paragraph BC 14 of the draft Practice Statement, ESMA is of the view that a non-mandatory guidance supporting IAS 1 would also help to emphasise that the concept of materiality is pervasive throughout IFRS and at the same time become more visible and accessible for constituents.
4. In particular, ESMA notes that materiality is defined in IAS 1 and in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as well as in the *Conceptual Framework for Financial Reporting*. IAS 1 contains requirements for presentation of general purpose IFRS financial statements. As a result, ESMA believes that including additional guidance on application of materiality as Implementation Guidance to IAS 1 would fit to the existing objective and content of IAS 1.

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<sup>1</sup> Consultation Paper: Considerations of materiality in financial reporting, ESMA, 10 November 2011, ESMA/2011/373

<sup>2</sup> Feedback Statement, Considerations of materiality in financial reporting, ESMA, 14 February 2013, ESMA/2013/218

5. Furthermore, taking the form of Implementation Guidance to IAS 1, rather than a separate Practice Statement, would provide more visibility to this guidance and attract more attention from preparers of financial information when exercising their judgement on the application of the principle of materiality.
6. ESMA welcomes the proposed guidance as it provides an overview of the requirements related to materiality in a single place, including cross references to a number of existing standards, thus making the document readable on a stand-alone basis. ESMA is of the view that this content can be retained in the document even if it is issued as Implementation Guidance to IAS 1.
7. Finally, consistent with the discussion in paragraphs BC10 and BC17 of the Basis for Conclusions of the draft Practice Statement, ESMA suggests that the draft Practice Statement should reflect its objective and aim at promoting a greater understanding of the role of materiality in IFRS by all the parties involved in the issue or use of financial statements and at encouraging a more effective dialogue about materiality. In particular, the drafting of the Practice Statement should reflect that the understanding of materiality is relevant not only to preparers but also to other actors such as enforcers or auditors. In this context, ESMA notes that *ESMA Guidelines on Enforcement of Financial Information*<sup>3</sup> require enforcers, when determining materiality for the purpose of enforcement of financial information, to assess it according to the relevant financial reporting framework used as of its reporting date.

### **Question 2—Illustrative examples**

*Do you find the examples helpful in the [draft] Practice Statement? Do you think any additional practical examples should be included? If so, what scenarios should the examples address? Please be as specific as possible and explain why those example(s) would be helpful to entities.*

8. ESMA considers that examples on application of materiality are useful to illustrate the way judgement on materiality should be exercised and welcomes the fact that these examples illustrate both decisions to include and to leave out, so that focus can be brought on those areas where judgement is the most difficult to exercise.
9. ESMA agrees that the use of illustrative examples is helpful to make guidance more practical and support preparers in the decision process when applying the concept of materiality. In particular, ESMA welcomes the examples provided in the draft Practice Statement in paragraph 27 of the draft Practice Statement referring to accounting policies and uncertainties and paragraph 39 of the draft Practice Statement referring to leases and currency translations adjustments.

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<sup>3</sup> Guidelines: ESMA guidelines on enforcement of financial information, 28 October 2014, ESMA/2014/1293

10. ESMA also welcomes paragraph 79 of the draft Practice Statement referring to intentional misstatements but notes that the wording of paragraph 41 of IAS 8 distinguishes between material errors and '*immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows*'. In ESMA's view, and consistently with the line of arguments made in paragraph 79 of the draft Practice Statement, ESMA is of the view that errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows are material. Accordingly, ESMA suggests that the IASB reflects such understanding in paragraph 41 of IAS 8.
11. While ESMA agrees with the examples provided in paragraphs 53(a)-(c) of the draft practice statement, we also note that the considerations of materiality should reflect the assessment of materiality made by the management and the fact that some of the disclosure provided could be considered as material by their nature for instance, because related parties are involved.
12. ESMA does not believe that the example of IFRS 8 *Operating Statements* provided in paragraph 53(d) of the draft Practice Statement is helpful. Indeed, as pointed in the *ESMA Review of Accounting Requirements of IFRS 8*,<sup>4</sup> issuers tend to aggregate segments so that some relevant information might be lost. Furthermore, as a response to the post-implementation review of IFRS 8, ESMA noted that the IASB intends to propose an amendment to IFRS 8 in order to enhance its requirements when aggregating operating segments into reportable segments. Consequently, ESMA suggests replacing this example.
13. Finally, the IASB could clarify paragraph 76 of the draft Practice Statement as it refers to two different fact patterns for which different assessment of materiality might be appropriate. Consequently, ESMA suggests that these two fact patterns are discussed separately.
14. Despite the risk that too many examples would detract from the principles, additional practical examples could be helpful. In this regard, the addition of an explicit example on the effect of the assessment of stewardship on the materiality and a specific example on the assessment of materiality of disclosure of earnings per share would be particularly helpful.

### **Question 3—Content of the [draft] Practice Statement**

*The [draft] Practice Statement aims to propose guidance in three main areas:*

- (a) characteristics of materiality;*

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<sup>4</sup> Report, Review of European enforcers on the implementation of IFRS 8, 10 November 2011, ESMA/2011/372

*(b) how to apply the concept of materiality in practice when presenting and disclosing information in the financial statements; and*

*(c) how to assess whether omissions and misstatements of information are material to the financial statements.*

*It also contains a short section on applying materiality when applying recognition and measurement requirements.*

*Please comment on the following and provide any suggestions you have for improving the [draft] Practice Statement:*

*(a) Do you think that any additional content should be included in the Practice Statement? If so, what additional content should be included and why?*

*(b) Do you think the guidance will be understandable by, and helpful to, preparers of financial statements who have a reasonable level of business/accounting knowledge and IFRS? If not, which paragraphs/sections are unclear or unhelpful and why?*

*(c) Are there any paragraphs/sections with which you do not agree? If so, which paragraphs/sections are they and why?*

*(d) Do you think any paragraphs/sections are unnecessary? If so, which paragraphs/sections are they and why?*

*(e) Do you think any aspects of the guidance will conflict with any legal requirements related to materiality within your jurisdiction, or a jurisdiction in which you file financial statements?*

15. ESMA welcomes the issuance of the draft Practice Statement and agrees with the overall objective of assisting management in applying the concept of materiality to general purpose IFRS financial statements. ESMA is also of the view that the guidance on applying materiality could help other stakeholders, including auditors and accounting enforcers, to better understand the approach followed by the management when making judgement about materiality. The draft Practice Statement provides a useful guidance to preparers and should reflect the thought process that a preparer should go through to decide whether a particular item is material.

16. ESMA is of the view that the following elements of the guidance are particularly helpful:

- i. ESMA welcomes the reference made by the IASB in paragraph 29 of the draft Practice Statement to both 'individual' and 'collective' assessment of whether information is material or immaterial. In particular, ESMA welcomes the conclusion that even if information is not judged to be material on its own, it might be material when considered together with other information.

- ii. ESMA welcomes the guidance in paragraph 36 of the draft Practice Statement clarifying that in some cases disclosure of the fact that a particular issue is immaterial to an entity is helpful and can provide relevant information. ESMA highlights that during the financial crisis disclosure that an entity was not exposed to a particular risk was in itself in many cases material information.
  - iii. ESMA welcomes the guidance on both quantitative and qualitative assessment of materiality. In this context, it is important that the main focus of the draft Practice Statement is on applying materiality to disclosures, as that is the area, where qualitative aspects of materiality play a more significant role.
17. ESMA welcomes the guidance on application of principles of materiality in the primary financial statements and in the notes. However, ESMA believes the difference in the application of principles of materiality in the primary statements and other disclosures in the notes, if any could be explained more clearly.
18. ESMA considers that areas for which the application of the materiality concept is difficult and could be further clarified include the requirements on judgement and assumptions contained in paragraphs 122 and 125 of IAS 1.
19. ESMA also notes that paragraph 28 of the draft Practice Statement addresses situations, where assessing the materiality threshold is more sensitive. In this context ESMA suggests to add an additional example describing the analysis of the materiality concept in situation, where the negative result (loss) will change into positive (profit) by a very small amount.
20. Furthermore, ESMA suggests to further develop the example in paragraph 28(c) of the draft Practice Statement related to the assessment of materiality in relation to transactions with related parties, even if executed at market terms. In particular, a transaction between an entity and some of its related parties (such as the CEO or a Board-Member or family-members) could be considered material even if executed at normal terms as such transaction is pertinent for assessing the stewardship of the management as referred in the *IFRS Conceptual Framework for Financial Reporting*.

#### **Question 4—Timing**

*The IASB plans to issue the draft Practice Statement before the finalisation of its Principles of Disclosure project.*

*The IASB has tentatively decided to include a discussion on the definition of materiality, and whether there is a need to change or clarify that definition within IFRS, in the Discussion Paper for its Principles of Disclosure project (expected to be issued early next year). Nevertheless, the IASB thinks that to address the need for guidance on the application of materiality, it is useful to develop the draft Practice Statement now, rather than wait until the Principles of Disclosure project has been finalised.*

*The IASB does not envisage that the discussion about the definition of materiality or any other topics in its Principles of Disclosure project will significantly affect the content of the draft Practice Statement. Nevertheless, the IASB will make any consequential amendments to the draft Practice Statement as necessary following the completion of the Principles of Disclosure project. Do you agree with this approach?*

21. As far as the Practice Statement will not be significantly affected by the discussions on the definition of materiality or any other topics in the Discussion Paper on *Principles of Disclosure*, ESMA believes that the guidance should be published without waiting for the outcome of the Principles of Disclosure project.

**Other comments**

22. ESMA notes that the draft Practice Statement is not consistent when making references to other Standards such as IAS 1, IAS 8, IAS 34 and to the Conceptual Framework. References are made sometimes by quoting full paragraphs, summarising the information in the relevant paragraph or sometimes by including a footnote.