Federation of European Accountants
Fédération des Experts comptables Européens

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E-mail: commentletter@efrag.org

13 March 2012

Ref.: FRP/PRJ/SKU/SRO

Dear Ms Flores,

Re: FEE Comments on EFRAG Draft Comment Letter on ESMA Consultation Paper *Considerations of materiality in financial reporting*

(1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the EFRAG Draft Comment Letter on the Consultation Paper *Considerations of materiality in financial reporting* (the "Paper") issued by ESMA.

(2) Similarly to EFRAG, FEE welcomes the Paper as a useful contribution to the debate on materiality and its consistent application in practice. Materiality applies to recognition, measurement, classification and disclosure of financial items. It is also considered in the context of the financial statements as a whole. Materiality has been widely recognised as an auditing concept, however, it is clear that it is also an inevitable concept inherent in financial reporting, since only relevant information should be presented to users of financial statements to support efficient decision-making.

(3) The concept of materiality plays an important part in the debate on keeping financial statements fit for purpose in the 21st century. There are several initiatives that have been launched at national, European and global level looking into these issues, mainly in the context of improving relevance by reducing unnecessary disclosure burden and making the information provided less boilerplate and more meaningful. Examples of such initiatives include: EFRAG's pro-active project on Disclosure Framework in cooperation with the FASB, the IAASB Disclosure Project, the UK Financial Reporting Council Discussion Paper *Cutting Clutter,* the ICAS & NZICA Paper *Losing the excess baggage*, *Re-assessing the Value of Corporate Reporting* by ACCA as well as the recent proposals from the French ANC to simplify accounting obligations for small listed companies in Europe. In addition, the IASB is currently finalising its agenda for the next three years and many commentators, including FEE, have suggested that they take on a project on disclosures with a view to limit disclosures to relevant items only.

(4) Our main comments to the Paper are summarised below:

Need for consistent understanding and application of materiality concept on global level

(5) The materiality concept is inevitably linked to the exercise of subjective judgement. We acknowledge that there may be a different understanding or application of materiality in practice among preparers, auditors and users of financial statements as well as among supervisory authorities charged with enforcing financial reporting.

(6) Materiality is a concept subordinated to relevance and is an integral part of IFRSs and other general purpose financial reporting frameworks, and is therefore also addressed at length in the International Standards on Auditing (ISAs). More consistent understanding and application in this area at a global level is definitely desirable.

(7) Inconsistent application of materiality needs to be addressed based on users' needs and we believe that, as is stated in the IFRS framework, capital providers should continue to have primacy in determining materiality. Such an approach, if properly directed and shared by preparers and auditors, is also likely to cover the main needs of other stakeholders.

(8) We fully support promotion of the principles of relevance and materiality in financial reporting since we believe progress is necessary to focus corporate reporting on key issues, providing users of annual reports an informative insight into the reporting entity, its performance and financial position, without irrelevant clutter of data or boilerplate description provided merely to formally meet requirements in a standard.

Next steps - important input to the IASB agenda

(9) In the February 2012 meeting of the IFRS Advisory Council, there was broad consensus among IASB stakeholders that a project on presentation and disclosures, based on a further consideration of the concept of materiality, should be a priority project for the IASB. We expect the IASB therefore to take action in this area in the short term.

(10) ESMA's Consultation Paper is a useful contribution to this wider debate of the relevance of financial reporting and therefore we believe that the responses ESMA receives on this Paper will provide very useful input to such an IASB project.

(11) We believe that it is best that this issue is addressed by standard setters at the global level. Consequently, we agree with EFRAG, that ESMA on its own should not develop further guidance on the concept of materiality directed to preparers or auditors.

(12) Our responses to the specific questions in the Paper as well as to the additional comments made by EFRAG are contained in the Appendix to this letter.

For further information on this letter, please contact Sylwia Kujawa, Project Manager, at FEE Secretariat on +32 2 285 40 86 or via email at sylwia.kujawa@fee.be.

Yours sincerely,

Philip Johnson
President

Q1: Do you think that the concept of materiality is clearly and consistently understood and applied in practise by preparers, auditors, users and accounting enforcers or do you feel more clarification is required?

(13) Like EFRAG, FEE acknowledges the fact that there are some practical issues arising from different approaches to materiality by different stakeholders.

(14) Even though one could argue that the concept of materiality is well defined in IFRSs, it might not be clearly understood. In practice the application of materiality involves a degree of judgement. Therefore, we acknowledge that the understanding and application of this concept may differ in practice among preparers, auditors, users of financial statements as well as enforcement authorities. In particular, it seems that there is a difference in understanding and application of the concept between the preparers and the auditors on one side and enforcers on the other.

(15) Significant diversity in practice in the application of materiality in IFRSs among preparers, auditors, enforcers and among different entities is undesirable.

(16) Materiality is currently defined within IFRSs and regarded as an entity-specific aspect of relevance based on the nature or magnitude, or both, of items to which the information relates. Because it is entity specific, materiality is by definition subject to judgement in particular facts and circumstances, based both on qualitative and quantitative considerations. It would be unrealistic therefore to expect to achieve uniformity in the application of the concept of materiality.

(17) Nevertheless, we would support development of further guidance, in particular on qualitative factors, but only at a global level. In addition, we note that auditing standard setters, such as the IAASB, provide additional guidance on the issue to the auditors and it is important that this guidance is consistent with any further guidance developed by the IASB.

Q2: Do you think ESMA should issue guidance in this regard?

(18) No, we do not believe that ESMA itself should issue guidance. In line with EFRAG, we believe that the IASB is best placed to provide any further guidance.

(19) We understand that ESMA, as the European supervisory authority, is aiming at achieving a consistent approach amongst European accounting enforcers. The debate that this Paper has triggered, at national and European level, has been useful already to obtain a better understanding of the differences in opinion that exist between the various stakeholders and between national regulators within the EU with respect to materiality.

(20) However, since the concept of materiality in IFRSs is a global one and impacts the work of both the accounting and auditing profession around the world, we would not support the issuance of guidance on materiality by ESMA to the capital markets participants. We are also concerned about the risk that such guidance could become a distinct European interpretation of how materiality is to be understood and applied. Any guidance issued by ESMA, because of the fact that ESMA is the European

supervisory authority, would carry considerable weight. We believe that the main aim should be to develop a global approach to both accounting and auditing.

(21) In the February 2012 meeting of the IFRS Advisory Council, there was broad consensus among IASB stakeholders that a project on presentation and disclosures, based on a further consideration of the concept of materiality, should be a priority project for the IASB. We would therefore expect the IASB to take action in this area in the near term.

(22) FEE regards ESMA's Consultation Paper as an important contribution to this wider debate of the relevance of financial reporting. The responses ESMA receives on its Consultation Paper can serve as very useful input to such an IASB project.

(23) Possibly the IASB could find inspiration in the guidance provided by auditing standards setters. The IAASB provides more guidance on how to determine quantitative materiality (see ISA 320 *Materiality in Planning and Performing Audit*), including different appropriate bases and ranges of percentages for quantitative materiality. Some of this guidance could also be useful for preparers.

Q3: 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.

(24) We think that the main objective of financial reporting is to provide a fair view of the financial position of an entity in order to enable the users to make informed economic decisions, which includes providing resources to the entity.

(25) Therefore, like EFRAG, we believe that both quotes mean ultimately the same. FEE is not aware of any examples where this slightly different wording gave rise to actual issues in practice.

(26) We believe that 'economic decision' should not be restricted to forward looking economic decision-making by capital providers when deciding whether to buy or sell instruments in the reporting entity. Economic decision-making also includes an assessment of how management have discharged their stewardship responsibilities. In this context, providing information that serves as a record of accountability for past actions as well as providing information of a more predictive nature are equally of importance for capital providers when making their investment decisions.

Q4: Is it your understanding that the primary user constituency of general purpose financial reports as defined by the IASB in paragraph 13[1] includes those users as outlined in paragraph 16[2] above? Please explain your rationale and if possible provide further examples.

[1] This paragraph number relates to the ESMA Consultation Paper.
[2] This paragraph number relates to the ESMA Consultation Paper.

(27) We do not agree with EFRAG that both paragraphs (13 and 16) describe the same group of users.

(28) Primary users of general purpose financial reports have been defined in the IASB *Conceptual Framework for Financial Reporting* as existing and potential investors, lenders and other creditors making decisions about providing resources to the entity. We would suggest following that definition. However, it should be recognised that the consequence of such definition is that users, who make economic decisions that do not involve providing resources to the entity, are then not considered primary users of general purpose financial reports.

(29) Focusing on the information needs of investors should generally meet most of the information needs of a wider range of users, including regulators. FEE elaborated on that in its response to the International Integrated Reporting Committee Discussion Paper *Towards Integrated Reporting – Communicating Value in the 21st Century* issued on 14 December 2011. In order to accommodate, to the extent possible, the needs of many different stakeholder groups, the long-term responsible investors' needs should be addressed as a priority. Such an approach, if properly directed, is likely to cover the main needs of other stakeholders while a reverse approach would not achieve as much.

(30) As we pointed in our response to the IASB *Exposure Draft on an improved Conceptual Framework for Financial Reporting - Chapter 1 The Objective of Financial Reporting, and Chapter 2 Qualitative Characteristics and Constraints of Decision-useful Financial Reporting* issued in October 2008, the primary user group needs to be sufficiently narrowly defined to be able to decide what should be included in a standard, for instance in deciding whether information should be more performance oriented or liquidity oriented. Different user groups have different information needs when taking meaningful decisions.

(31) An excess in the quantity of information, resulting from an attempt to respond to the needs of too many diverse stakeholders, would reduce the readability and hence understandability of the financial statements and impair their quality. Thus, financial reporting prepared for other purposes, to meet regulatory requirements or simply directed towards meeting the information needs of other users, is likely to result in an additional burden on the already voluminous corporate reporting. This would be counterproductive to the objective of providing clear and relevant information to the primary users.

(32) In general, FEE agrees that there are numerous stakeholders other than primary users interested in the financial statements. Nevertheless, we believe it is not really relevant to the discussion on consistent application of the materiality concept as financial reports are prepared to satisfy the information needs of the primary users.

(33) In case of information reported based on regulatory requirements but included in financial reports, the assumption of investors being the primary users may not be true and other additional thresholds may need to be considered.

Q5a: 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.

(34) We agree with EFRAG that the distinction between the above words is one of semantics and that no practical implication should flow from making such distinction.

(35) We believe that there should not be any difference between the accounting and auditing definitions and it was not the intention of the standard setters. Thus, in our opinion, the use of different words does not imply various materiality thresholds.

(36) However, this question should be raised with the IASB and the IAASB rather than the public. To avoid confusion and to counter any further interpretation discussions in the future, it could be suggested that the IASB and the IAASB should consider aligning the wording.

Q5b: 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?

(37) As stated above, we do not believe that slightly different wordings in auditing and accounting standards lead to different assessments of materiality for auditors and preparers. We are not aware of any such instances in practice.

(38) It could be an idea to keep the definition more simple and pragmatic. It would be desirable to use less technical language as the discussion on materiality often becomes theoretical and not understandable for the broad audience of preparers, auditors and users, even if they have knowledge about general financial statements and financial information.

Q6a: 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.

(39) We agree that 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. This is because, according to the IASB Framework, materiality is an entity specific element of relevance that is to provide information that is relevant and important to the primary users in making economic decisions. The overriding objective is to assess materiality in accordance with this definition.

(40) FEE agrees that an overall materiality threshold to be applied across all transactions or balances cannot be defined numerically. Therefore, different materiality thresholds will be applied depending on the particular aspects of the financial statements.

Q6b: Do you agree that each of the examples provided in paragraph 21 a – e[3] 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.

(41) In our opinion the examples as provided constitute possible instances where the quantitative materiality can be lower.

(42) We note that whether breaches of legal or regulatory requirements are material depends upon the potential financial consequences of the breach. There may be many instances where such breaches have negligible consequences, and are therefore not material. In addition, unusual or non-recurring transactions may also not be material – just because they are unusual or non-recurring does not make them material, unless there are other qualitative considerations involved that imply a greater financial impact.

(43) We agree that transactions with related parties, reversals in trends, and key ratios or metrics often require a materiality level that is lower than that for the financial statements as a whole. Determination of both materiality for the financial statements as a whole and the lower levels of materiality for certain other items require the consideration of qualitative factors and therefore application of judgment.

(44) The list with examples of matters requiring a materiality level that is lower than that for the financial statements as a whole is not exhaustive. We doubt whether it would be possible to develop a list covering all likely instances. Also, the examples would, in some instances, differ from one industry to another. While a quantitative analysis may sometimes be practical for a first assessment of materiality, the overall test remains whether “omissions or misstatements that could individually or collectively influence the economic decisions of users made on the basis of financial reports” have occurred and consequently a mere quantitative analysis cannot appropriately be used as a substitute for a full analysis of all relevant factors.

(45) We note that the examples provided in the paragraph 22 include qualitative ones. Those are important in the context of the current developments in financial reporting, including integrated reporting.

(46) The nature of qualitative disclosures and their usefulness are wholly dependent on judgement applied by management (to the extent possible) on a consistent basis from one reporting period to another (to the extent possible). Qualitative disclosures may be considered as material or immaterial for the primary users depending on their relevance and how these disclosures could impact on the economic decisions of such users.

[3] This paragraph number relates to the ESMA Consultation Paper.

Q7: 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.

(47) We agree that preparers should assess the impact of all misstatements, including omissions, also those from prior periods that are of continued applicability in the current period, when making decisions on the materiality of those misstatements, unless such misstatements are clearly trivial. According to IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors" such omissions or misstatements of items should be considered individually and collectively and also by size and nature. They may impact the economic decisions of users taken on the basis of the financial statements.

(48) Consequently, auditors need to consider prior and current period misstatements for the purposes of the audit report. The results of such consideration can impact the contents of their report.

(49) We believe that the current guidance in IAS 8 is sufficient to assess the impact of prior period misstatements, including omissions.

Q8: Do you agree that preparers of financial reports should assess the impact of all misstatements and omissions as referred to in paragraphs 23 to 26[4] above in determining materiality? Please explain your views in this regard and provide practical examples, if applicable.

(50) We agree that preparers should assess the impact of all misstatements, including omissions, as covered by the paragraphs 24 to 27, unless these are clearly trivial.

Q9a: Do you believe that an accounting policy disclosing the materiality judgments exercised by preparers should be provided in the financial statements?

(51) Like EFRAG, we would not support such disclosure if this implies the provision of details behind each materiality judgement, i.e. an evaluation of whether an individual item is material or not. We do not believe that it is possible to give this detailed information in a meaningful way. We are concerned that, if such a disclosure requirements were imposed, it would only lead to "boilerplate disclosures" about materiality assessments that would provide little insights into, by its nature, subjective judgements made by management with respect to its decisions regarding materiality on specific issues and items.

Q9b: If so, please provide an outline of the nature of such disclosures.

(52) Please see our answer to Question 9a above.

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

Q9c: In either case, please explain your rationale in this regard.

(53) Please refer also to our answer to Question 9a above.

(54) Furthermore, we find the requirement in IAS 1 "Presentation of Financial Statements" to be sufficient in the context of materiality evaluations. We suggest that any specific requirements should be avoided as many disclosures are entity or industry specific and, as a result, depend on various individual circumstances. IAS 1 states that *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.*

(55) The "stand-back" overall evaluation by the preparers and by the auditors in the final stages of financial reporting process is important to ensure that all relevant disclosures are being included that could impact the amounts recognised in the financial statements materially and thus the economic decisions of the users.

Q10: 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.

(56) No. We do not agree that omission of a note about a material line item automatically constitutes a misstatement.

(57) The decision, whether a particular note is or is not material, will depend on the nature and extent of the disclosure.

(58) A conclusion that an omission of a note to a material line item in the financial statements automatically constitutes a misstatement could lead to excessive and irrelevant disclosures, which could reduce readability and understandability of the financial statements.

(59) As FEE has already mentioned above, materiality of the disclosures should be judged in relation to the overall needs of the users and their relevance in particular to their economic decisions. Please also refer to our answer to Question 6a of this Paper.

Q11: 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:

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.

(60) In line with EFRAG, we believe that entities need to apply judgement to assess whether individual disclosures are material or not.

(61) FEE believes that, when considering the materiality of any note to the financial statements, an emphasis should always be placed on whether its disclosure is relevant to the primary users and could impact their economic decisions.

(62) For disclosures that are not directly linked to a line item in the financial statements, determining whether a disclosure is materially misstated, depends upon whether the misstatement, in itself or in conjunction with other disclosures or misstatements in the context of the financial statements as a whole, would reasonably be expected to change the economic decisions of users. In the case of quantitative note disclosures, either the quantitative materiality level for the financial statements as a whole would apply, or a lower level of materiality, if necessary.

Q12: 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?

(63) According to IAS 34 "Interim Financial Reporting" the concept of materiality has to be applied when recognising, measuring, classifying and disclosing any item for the purposes of the interim reporting in the same way as in the case for the annual report. IAS 34 does state however that *in making assessments of materiality, it shall be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data*. The numbers in the interim financial statements are different from those for the full year of which they will form part. Thus, what is material in one context will not necessarily be material in the other.

(64) Nevertheless, we agree with EFRAG that conceptually materiality should be assessed in the same way, when being determined and applied, in both the interim and annual financial reports. The mere fact that interim figures may rely more on estimates does not and should not change the way materiality assessment is performed.

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Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986