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15 March 2012

Dear Françoise

EFRAG Draft Comment Letter on the ESMA Consultation Paper 'Considerations of materiality in financial reporting'

Thank you for providing the UK Accounting Standards Board (ASB) with the opportunity to comment on your draft comment letter (DCL) to the ESMA Consultation Paper (CP) 'Considerations of materiality in financial reporting'.

The ASB broadly agrees with the EFRAG DCL. Similar to EFRAG, we believe that it is the role of the IASB, not ESMA, to provide any guidance on the application of materiality.

We have responded to ESMA on its CP and a copy of our response is attached for your information.

Should you have any queries regarding this response please contact Deepa Raval, Project Director, on +44 207 492 2424 or by email d.raval@frc-asb.org.uk.

Yours sincerely

Roger Marshall

Roger Marshall
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Frederiek Vermeulen
ESMA
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15 March 2012

Dear Mr Vermeulen

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

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the ESMA Consultation Paper (CP) '*Considerations of materiality in financial reporting*'.

We believe that there is a need for a consistent approach to the application of materiality for financial reporting purposes. That said, the ASB does not believe that it is appropriate for an enforcement authority to provide guidance on the application of accounting standards. We believe that it is the role of the IASB to issue such guidance.

We believe that materiality for regulators should not be different to standard setters, preparers and auditors. Therefore, we would recommend that ESMA provide input to those parties to agree a common approach for the application of materiality in practice. Given that there are other financial reporting groups currently considering the issue of materiality, we believe that publication of a report by ESMA at this point in time could result in confusing messages about the application of materiality.

Our detailed responses to the questions in the CP are included in the Appendix to this letter. However, our overall comments are below:

a) *Cutting clutter* – we believe that there is a need for guidance by the IASB on what materiality means from a disclosure perspective, with a view to reducing the disclosure burden. Historically, disclosures have partly been driven by concerns, either from preparers or auditors, of regulatory criticism and partly from compliance with rule based, anti-avoidance, disclosure requirements in IFRS. This has resulted in financial reports being cluttered with immaterial information that can obscure relevant information. In the UK, practice is developing where preparers, auditors and regulators are taking a more careful view and focusing on providing disclosures which are relevant to users.

b) *Users of financial statements* – The objective of financial reporting differs from the objectives of enforcers and we believe that there is a need for financial reports to focus on the primary users, otherwise there is a risk that financial reports will continue to expand. Fundamentally, financial statements are not produced to meet the demands of securities regulators. We do feel that ESMA has an important role in encouraging regulators to focus on requiring important disclosures and avoid through their actions causing preparers and auditors to feel that they need to make boiler plate or trivial disclosures. As noted above these merely impede the comprehension of the significant disclosures.

c) *Materiality is entity specific and requires the application of judgement* – In our view, materiality is an overlay that would be applied by a preparer to determine whether a particular requirement in an accounting standard is relevant to the entity. This will require the application of judgement. Therefore it follows that if an item is required by a financial reporting standard then that does not necessarily mean that the item is material. We believe that an approach whereby information is always provided when required by an accounting standard encourages a compliance approach to financial reporting and may not necessarily result in useful information; it is also not the intended application of the concept of materiality.

If you would like to discuss these comments, please contact myself or Deepa Raval on 020 7492 2424.

Yours sincerely

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Appendix: responses to questions set out in the CP

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?

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

Q1. Yes. We believe that the concept of materiality, as defined in the IASB's Conceptual Framework is clear. We note that the concepts and general characteristics of materiality in International Standard of Auditing (ISA) 320 'Audit materiality' are based on IFRS. ISA 320 goes on further to state that materiality for audit purposes is determined with reference to the relevant financial reporting framework (paragraph 3).

Materiality remains a principles based concept that is entity specific and requires the application of judgement in practice. For materiality to apply effectively it is not possible to develop rules to determine which items are material.

We believe that more guidance is required for the application of materiality in practice for disclosures. We believe that materiality is not being applied as robustly to disclosures as compared to recognised and measured amounts in the financial statements and reinforcing the messages in this area would be helpful. This was one of the recommendations in the UK Financial Reporting Council's (FRC) discussion paper 'Cutting clutter'.

Q2. No. As noted in our covering letter, we do not believe that it is appropriate for ESMA to be issuing guidance on materiality. This is the role of the IASB.

We note that the ASB, the European Financial Reporting Group (EFRAG), and the French Standard Setter, the Autorité des Normes Comptables (ANC) are looking at the issue of materiality as part of their joint Disclosure Framework project as are the US Financial Accounting Standards Board (FASB). We would recommend that ESMA provides input into those projects rather than issuing a report on a standalone basis.

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.

Q3. No. In our view, 'economic decisions made by users' goes beyond the decision to just provide resources (as stated in the objective of financial reporting in the current Conceptual Framework) as it incorporates the stewardship objective of financial reporting. Stewardship is a notion based around the accountability of management for the resources entrusted to it[1]. We believe that the stewardship objective should be considered in making an assessment of materiality. Furthermore, the decisions

[1] Stewardship was considered in detail in a Pro-active Accounting Activities in Europe paper 'Stewardship/Accountability as an Objective of Financial Reporting'.

that users' make are not just about providing resources to the entity, for example, trading decisions.

Q4: 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.

Q4. No. The IASB's Conceptual Framework (OB2 & BC1.9) is clear that primary users are "existing and potential investors, lenders and other creditors". The Conceptual Framework goes on to state that "other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed at those other parties".

We believe that the reference to paragraph 16 of the CP in question 4 above should be a reference to paragraph 15 as paragraph 16 lists the type of decision and not the users. The users listed are a wider group than those included in the definition of primary users set out in the Conceptual Framework.

"It is obvious that the information contained in the financial statements is useful to a wider group than just the primary users identified above. There are many stakeholders with an interest in an entity's financial reports including (but not limited to) existing and potential investors, employees, lenders, suppliers, customers, regulators and other Government agencies and the public….It is assumed that all users of financial statements are interested in whether the financial statements achieve a fair presentation and the presumption is that financial statements will comply with the accounting standards".

We believe that the explanation of the primary users are in the Conceptual Framework is clear "investors, lenders and other creditors". BC1.10 of the framework explains that employees are covered by 'other creditors'.

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.

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?

Q5a. No. We do not believe that the differences in wording would lead to application of different materiality thresholds in practice.

Q5b. No. As noted in our response to question 1, we believe that materiality as a concept is clearly understood by both standard setters and auditors.

The inclusion of the words 'reasonably expected to' highlights that financial statements are prepared with a reasonable user in mind and materiality is not determined to meet the needs of a particular user group . In practice, preparers are likely to take a similar approach. The Conceptual Framework includes a similar concept "general purpose financial reports are intended to provide common information to users and cannot accommodate every request for information". We would not expect a there to be a different assessment of materiality for auditing purposes than for financial reporting purposes.

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.

Q6b: Do you agree that each of the examples provided in paragraph 21 a – e above constitute instances where the materiality threshold may be lower? Are there other instances which might be cited as examples? Please explain your rationale.

Q6a Yes. The accounting and auditing standards clearly state that an item can be material by size or nature and the two need to be considered together. That said, we believe that determining whether an item is material with reference to primary financial statement totals is a useful guideline in making an assessment of whether an item is material in the context of the financial statements as a whole. However, a range of factors need to be considered in making an assessment of materiality including qualitative considerations and the context. We do not consider that it is necessary or practicable to calculate different materiality levels for each line item in the financial statements as materiality needs to be considered in the round.

Q6b. No. We do not believe that it is appropriate to come up with a list of transactions where the quantitative materiality threshold may be lower. Lists can be dangerous as they imply that the requirements must be complied with and encourage 'checklist' behaviour. As noted in our covering letter, materiality requires the application of judgment and whether the item is considered to be material will depend on the specific circumstances of an entity.

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.

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

Q7&8. Yes. We agree that preparers should assess the impact of all misstatements and omissions in determining materiality decisions as individually or in aggregate they could be material.

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

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

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

Q9a & 9c. No. It would be difficult to articulate all the materiality judgements that are made by preparers in an accounting policy note. As discussed in question 6 above, the assessment of materiality is not made on one quantitative number but by taking a range of factors into account.

There is a general requirement in IAS 1 to disclose in the summary of significant accounting policies, the judgements that management has made in the process of applying those policies.

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.

Q10. No. If a line item in the primary financial statements is considered to be material that does not necessarily mean that all the information that would be required in a note would be material. Materiality needs to be applied to the information that is required by a standard relating to a material line item.

Some notes are a disaggregation of line items in the primary financial statements, if individual elements of the disaggregated information are not material it should not normally be necessary to provide further information about those elements. As an example, the fixed asset line item may be material but the only material movement relating to that line item may be the additions in the year. Therefore, we would question whether all the components of the fixed asset note need disclosure if some of the components are not material.

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.

Q11. We note that a number of items typically found in note disclosures do not relate to line items on the face of the primary financial statements or relate to items that are not recognised e.g. contingent liabilities. We believe that the same considerations for determining materiality should apply in these circumstances. For example, information on risk exposures should only be provided to the extent that an entity has a material exposure to a particular risk.

In limited circumstances (e.g. sovereign debt crisis) disclosure that there is no exposure to a particular country might be relevant to users. However, over the last few years disclosures in the notes have expanded including more narrative information (e.g. describing risk exposures and risk management processes) and there is a broader question of the purpose of the disclosures in the notes and whether some disclosures should be provided elsewhere in the financial report such as in management commentary.

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?

Q12. IAS 34 *Interim financial statements* is clear on the application of materiality to interim financial reports. That standard states "that materiality shall be assessed in relation to the interim period financial data. 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" (paragraph 23).