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Att.: Chairman Francoise Flores
By e-mail: Commentletter@efrag.org

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Dear Francoise Flores,

Re. EFRAG Draft Comment Letter: ESMA Consultation Paper – ***Considerations of materiality in financial reporting***

The Danish Accounting Standards Committee set up by "FSR – danske revisorer" is pleased to respond to EFRAG's Draft Comment Letter on the European Securities and Markets Authority's (ESMA's) Consultation Paper *Considerations of materiality in financial reporting*.

The Committee is very pleased with EFRAG's decision to respond to the Consultation Paper from ESMA. We have discussed the EFRAG Draft Comment Letter in our 26 March 2012 meeting and we generally agree with the comments and observations made by EFRAG. Especially, we strongly support the message that any clarification of the concept of materiality in financial reporting should be developed by the IASB as we see them being the most obvious candidate to explain how the concept of materiality should be applied in the standards they develop. In addition, this would make sure that clarification is being done at an international level rather than at a regional/jurisdictional level. We see any clarification as an international rather than a regional/jurisdictional exercise. It is not desirable to potentially have regional/jurisdictional variations to the concept of materiality when dealing with standards that are applied globally.

In our experience the main issue is about how materiality is applied to the massive disclosure requirements in IFRS's. Rather than develop guidance we think ESMA should approach the IASB and share the concerns experienced by their members and, as a result, encourage the IASB to have development of a disclosure framework as a top priority on their agenda.

As an appendix to this letter we have summarised observations made by the Danish Accounting Standards Committee when discussing EFRAG's draft comment letter.

We would be happy to elaborate further on our comments should you wish so.

Kind regards

Jan Peter Larsen Chairman of the Danish Accounting Standards Committee	Ole Steen Jørgensen Chief consultant FSR – danske revisorer

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?

We agree with EFRAG's response. In respect of the observations we agree in particular with the observation in para 6 that a different understanding of materiality might have resulted in a "pass the checklist" type of approach.

It seems that there is a difference in understanding of the concept of materiality between the preparers and the audit profession on the one side and enforcers on the other side. One example where this comes out is when the concept of materiality is applied to disclosures, and where it may be considered whether there is a level playing field.

To illustrate: An entity might have determined that a disclosure requirement is not material and with reference to IAS 1:31[1] leaves out the disclosure. If the enforcer disagrees, the entity often will end up having to disclose the information anyway.

This might be the result of an uneven playing field where the burden of proof on the entity to document that the omitted disclosure <u>could not influence</u> the economic decisions that users make is perceived to be more tough for the entity to overcome than it is for the enforcer (who in addition has enforcement powers) to insist that the disclosure <u>could influence</u> the economic decisions that users make.

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

We agree with EFRAG's response.

We do not think that ESMA should issue guidance, but leave it to the standard settings bodies (IASB and IAASB) to develop further material in their respective standards on the subject. The reason being that materiality is a global issue and not a regional issue. The practical use of materiality should ideally be the same in any region of the world.

In addition to the observations made in para 9: We wonder to whom such guidance would be directed, and whether it is sound for a body comprising enforcers only to issue guidance. ESMA can of course do that to promote consistency between European enforcers/regulators. We do see a potential risk of

[1] IAS 1:31 An entity need not provide a specific disclosure required by an IFRS if the information is not material.

such guidance focusing more on rules that would be easy to enforce than on principle-based guidance on materiality.

The same would be the case where a regulator also has financial supervisory responsibilities within its remit. We think it may run the risk of having materiality for financial reporting purposes commingling with materiality for financial supervisory purposes. This ultimately also could lead to a view on materiality not reflecting its role in a principle-based set of accounting standards, but rather as a tool to ease enforcement for financial supervisory purposes. This is not to suggest in any way that this is not also an important role, but we think the two roles serve different purposes.

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.

We agree with EFRAG's response that the quotes convey identical messages. We are not aware of any examples where this slightly different wording gave rise to actual issues in practice.

The wordings are taken from two different pieces of the IFRS literature and issued at quite different points in time. It would not be desirable if use of more or less similar wording requires dissecting to grasp an intended yet narrow understanding of the English language.

If that was the case, how would that interact with EU translated text which is the legally binding text in Member States? Has it been evaluated whether all different translations into Member State language have exactly the same meaning? Should ESMA want to go into such fine nuances with the original text, we believe it would require a full evaluation of the same text in all Member State official languages.

In our view, the better solution here is to call for standard setters to apply consistent and clear language in their original text.

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 out-lined in paragraph 16 above? Please explain your rationale and if possible provide further examples.

We agree with EFRAG's response. 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. Following that definition would in our view generally meet most of the information needs of a wider range of users including regulators.

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?

We agree with EFRAG's response that there should not be any difference between the accounting and auditing definitions. We also do not think it was ever the intention of the two standard setters for there to be any difference. We think this is something the IASB/IAASB are both better placed to respond to.

The difference between the words might have been influenced by the fact that it is difficult to assess whether information or an omission would affect the users, because not all users react in the same way on given or omitted information, but the prepares and the auditors should think about whether it could influence users. Without this being further researched we find it difficult to actually respond to the question raised by ESMA.

Once again, we think it calls for standard setters to consider applying consistent and clear language.

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 constitutes instances where the quantitative materiality threshold may be lower? Are there other instances which might be cited as examples? Please explain your rationale.

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.

We agree with EFRAG's response.

Q6a: We generally believe that materiality should be judged against the overall information needs of the users. According to the IASB Framework materiality is an entity specific element of relevance that is also relevant and important to the users. Materiality, therefore, should be assessed in accordance with this definition.

We do not think a numerical materiality threshold can be determined solely on, say, the amount of turnover, the amount of net profit/loss, the amount of total assets or the amount of equity. Different materiality thresholds will be applied depending on the particular aspects of the financial statements.

Notwithstanding this observation, we are troubled by the text in Q6a "... *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* ..." if the text suggests that materiality should be assessed based on size of the amount of the individual line items. Again, we believe materiality should be judged against the overall needs of the users.

To explain, we would not agree if the text in quotation marks suggests that a small amount in a line item automatically requires a lower threshold for materiality as regards information given in the notes. In fact, IAS 1:31 acknowledges the fact that an entity need not provide a specific disclosure required by an IFRS if the information is not material. Disclosure may be required on grounds other than materiality, for instance if it is an unusual transaction with a related party.

Similar considerations apply if the amount of the line item is large. A large amount in a line item should also not automatically lead to a note disclosure. This could be the case where the content of the line item is clear based on the text of the line item itself (e.g. cash or trade receivables) and it is determined at the same time that further disaggregation would not affect users.

Q6b: We agree that the examples in paragraph 22 (a)-(e) represent circumstances that would be considered in determining whether an item is material. They should, however, only be seen as indicators that further consideration is required. They do not represent circumstances in which an item should automatically be deemed material.

Adding a list of examples is always useful, but it should be used with caution. We do not think it is possible to develop an exhaustive list covering all likely instances. So while the list of examples is helpful, it should not set aside the overall test being whether "omissions or misstatements … could individually or collectively influence the economic decisions of users made on the basis of financial reports".

In case of "an unusual or non-recurring transaction(s)/balance(s)", we even think it is debatable whether they create a lower threshold. Entering into a derivative contract of a type not normally used by the entity to reduce a risk or entering into a transaction which occurs rarely would still be a normal part of the entity's business even if unusual or non-recurring.

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.

If ESMA is asking for a numerical value of materiality being disclosed, it is a concern to us because such a requirement potentially might lead to a misconception that materiality is solely a quantitative consideration and that all figures in financial statements are prepared using a level of precision equivalent to that numerical value.

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.

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.

We agree with EFRAG's response.

Referring to our observations made in Q6a, we do not agree that omission of a required note giving additional information about a material line item necessarily constitutes a misstatement. If we were to believe so, it would seem to put IAS 1:31 out of play. The materiality of the line item to which the note relates would be a relevant - but not the only - factor in assessing materiality and hence whether the disclosure is required. As already mentioned, we think materiality of the disclosures should be judged against the overall needs of the users and their relevance to them.

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?

We agree with EFRAG's response.