EFRAG
European Financial Reporting Advisory Group

Steven Maijoor
Chairman
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103 Rue de Grenelle
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France

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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. In applying those requirements, it is important that any additional information be justified by showing how it 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

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 may be helpful to reach a better common understanding of how the concept of materiality should be applied, reviewed and enforced.

1 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.

2 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.

3 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.

4 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.

5 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.

EFRAG's response

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

6 Although 'decisions about providing resources to the entity' may be seen as only a subset of economic decisions made by users, EFRAG does not see a real difference between the two expressions within the context of the discussion about materiality. 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.

7 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.

8 EFRAG believes that there is merit in strongly encouraging the IASB to ensure that consistent wording is used throughout the IFRS literature to avoid the potential confusion wording differences create for those applying the standards.

Question 4

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 above[2]? Please explain your rationale and if possible provide further examples.

EFRAG's response

EFRAG believes the list of users in the framework (OB2) is clear, and that this list should be used as a reference when materiality is applied. EFRAG therefore does not believe that the list in paragraph 16 should be referred to.

9 Although it could be argued that not all the parties mentioned in paragraph 16 are primary users of financial statements, EFRAG believes that 'users' are defined clearly enough in the Framework (OB2). Furthermore, EFRAG believes that the distinction does not have practical implications in the application of materiality given the objective of financial reporting in the Framework.

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?

[1] The paragraph number refers to the ESMA consultation paper.
[2] The paragraph number refers to the ESMA consultation paper.

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[3]

(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[4] constitute instances where the materiality threshold may be lower? Are there other instances which might be cited as examples? Please explain your rationale.

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.

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

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

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

[5] 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).

10 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.

11 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.

12 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.

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.

13 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.

14 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.

15 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[6]

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.

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:

(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.

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.

16 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 in 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?

EFRAG's response

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

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

17 It is noted that, according to paragraph 23 of IAS 34, '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'. 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.