

European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

5 April 2012

Dear Sir

ESMA Consultation Paper - Considerations of materiality in financial reporting

We are pleased to comment on the above Consultation Paper (the CP). Following consultation, this letter summarises the views of the BDO network¹.

We welcome the action taken by ESMA to contribute to the debate around materiality. In addition to differing views about the precise determination of quantitative materiality, there are growing concerns around the increasing length and complexity of financial statements and the extent to which all of the disclosures that are typically included are necessary.

However, while we believe that it may be appropriate for enhanced guidance about materiality to be issued, we do not believe that it would be appropriate for ESMA to do this. Instead, we consider that this should be for the International Accounting Standards Board (IASB) and International Auditing and Assurance Standards Board (IAASB), in the context of their roles as the global accounting and auditing standard setters. ESMA might draw the attention of both Boards to comments received in response to the CP, and suggest that the issue is considered jointly from both an accounting and auditing perspective in order to bring greater consistency to the overall determination and application of materiality.

We agree that quantitative materiality should not be based solely on a comparison with certain primary statement totals, and that the effect on individual line items may need to be considered. It is also important that other facts and circumstances are taken into account, meaning that it is essential that materiality is determined from both a quantitative and qualitative perspective, together with consideration of the financial statements as a whole.

Qualitative characteristics of materiality are likely to be of greater importance when considering disclosures to be included in financial statements, as these encompass both numerical and narrative aspects. For example, while an item included in financial statements might, from a numerical perspective, be relatively small at a reporting date, its potential future changes in value might be highly material. Consequently, sensitivity information relating to the risk profile of the item and disclosures about the types of transactions that the

¹ Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels. Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network. BDO is the brand name for the BDO network and for each of the BDO member firms. BDO IFR Advisory Limited, registered in England No 7295966. Registered office: c/o Hackwood Secretaries Limited, One Silk Street, London, EC2Y 8HQ. © 2012 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

reporting entity enters into might be regarded as qualitatively material. Similarly, disclosures that are relevant to an entity's liquidity position may also be qualitatively significant, such as the classification of debt as short or long term and the classification of items included in an entity's cash flow statement.

We note that a number of accounting standard setters, institutes and other organisations (including the European Financial Reporting Advisory Group) have carried out research, which has looked in particular at how disclosures made in financial statements can be made briefer and more relevant. We believe that these studies are a valuable contribution to the debate, and that they link clearly to the question of materiality. In the context of disclosures, we suggested to the IASB, in our comment letter in response to its Agenda Consultation, that it would be appropriate for a Disclosure Framework project to be added to its active agenda as and when resources permit.

Our detailed responses to the questions in the CP are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300.

Yours faithfully



Andrew Buchanan

Global Head of IFRS

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?

While it is difficult to comment on whether all of the parties listed above have a consistent understanding of the concept of materiality, it appears that there is inconsistency in its application. Consequently, it would be helpful for guidance to be issued to clarify the appropriate approach (although please see our response to question 2).

For example, if an entity is contacted by a regulator regarding a particular reporting issue following a review of financial statements, it can be the case that the entity, when responding, will assume that the regulator has a very low materiality threshold. As a consequence, instead of the entity justifying in its response why a particular accounting approach has been taken, or (more commonly) disclosure omitted, on the grounds of materiality, it may simply agree to include additional information in its financial statements in future periods.

It is also the case that, due to the judgements involved in concluding whether a particular item is material, it is inevitable that there will be differing views as to what constitutes a material departure from the requirements of IFRS. Because IFRS is a principles based set of accounting standards, variation within an acceptable range of approaches will arise in practice, with the potential for companies, their auditors and regulators each taking a more or less conservative approach.

Question 2

Do you think ESMA should issue guidance in this regard?

While we welcome the CP and ESMA's contribution to the debate about materiality, which we believe is appropriate and timely, in our view it is for the International Accounting Standards Board in its capacity as the accounting standard setter and the International Auditing and Assurance Standards Board (IAASB) to consider the issue in more detail and promulgate any related standards. In addition, IFRSs and ISAs are applied globally and the issue of guidance by ESMA might bring the risk of jurisdictional interpretation of the requirements of those accounting and auditing standards, which we believe is inappropriate.

Consequently, we do not support the issuance by ESMA of guidance about materiality. Instead, ESMA might consider taking the results of its consultation to the IASB and the IAASB which we believe would be a helpful contribution to the international debate on this topic.

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.

We do not consider that there is a substantive difference between the two phrases. 'Economic decisions' and 'decisions about providing resources' have many similarities which extend beyond the decision of whether an investment should be made in, or funds lent to, an entity. They can be looked at widely, and can extend beyond the group of individuals and entities identified in the Framework; for example, a decision to purchase goods from an entity could be viewed as being both an economic decision (as the purchaser will have certain expectations about the use that can or will be made of the good or service purchased, and the vendor's financial position may affect an assessment of the likelihood of the good or service ultimately being delivered) and a decision about providing resources (as the payment for goods and services will provide resources to an entity).

Question 4

Is it your understanding that the primary user constituency of general purposes 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.

Yes. The primary focus is on those users of financial statements who take decisions based on those financial statements that might affect their future returns, whether from an investment, lending activity or trading activity.

We note that the IFRS Foundation Constitution might give the potential for a wider view of the use to which financial statements might be put. Paragraph 2(a) notes that:

'...to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions.'

We believe that this paragraph has been carefully worded, such that the constituency of potential users of IFRS financial statements can be considered to extend beyond the primary group of existing and potential investors, lenders and other creditors, to include other bodies such as government agencies and regulators.

Question 5a

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.

No. The use of the word 'could' is used, in our view properly, because it is not possible to the IASB to determine whether a particular accounting approach, or the inclusion or exclusion of certain disclosures, would in fact have an effect on decisions. Consequently, the focus needs to be on whether that information is capable of having an effect on decisions. This does not imply a higher or lower materiality threshold. However, it would be helpful for 'reasonably' to be included in the same way as in the Auditing Standards as this would more clearly indicate that the determination of materiality is judgemental.

Question 5b

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?

While the use of different terminology almost inevitably brings the potential for differing interpretations, we do not consider that in this case it gives rise to a substantive difference in approach. As noted above, the assessment and determination of what is material is subjective, and in practice there will be a range of acceptable approaches.

Question 6a

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 financial 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.

We agree, and note that paragraph 22 of the CP highlights a number of points that need to be taken into consideration, in addition to the effect of an item on the overall profit for the period or statement of financial position totals. In addition to those points, it would be appropriate to include consideration of whether users of financial statements are likely to pay particular attention to one or more particular line items, due to their significance to the entity as a whole.

Question 6b

Do you agree that each of the examples provide in paragraph 22 a - e 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.

We agree that each of the examples referred to above constitute instances where the quantitative materiality threshold might be lower than a materiality threshold set on the basis of a metric such as turnover, gross or net profit, or total assets. However, we also note that each of the examples might not have any effect on materiality.

In addition to the examples set out in paragraph 22, we believe that consideration of materiality also needs to include the effect of an item on subtotals and other line items within the primary statements, the extent to which an entity complies with its borrowing and other covenants, and any key assumptions made (such as those for the purposes of impairment testing) which could affect key aspects of an entity's reported financial performance, including compliance with borrowing and other covenants.

We also believe that a qualitative approach needs to be taken for the type of disclosures set out in paragraph 22, which should be extended specifically to cover liquidity (for example, the classification of obligations as short or long term, and the classification of items included in the cash flow statement).

Question 7

Do you agree that preparers of financial reports should assess the impact of all misstatement 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.

We agree that these factors should be assessed in determining whether there is, cumulatively or in aggregate, a misstatement of the financial statements. These factors may also be relevant when determining materiality; this might be appropriate, depending on which aspects of the financial statements the misstatements and omissions relate to. For example, this might include consideration of whether a particularly significant line item is affected (whether individually, or in the context of the financial statements as a whole), or whether there are transactions or events where a lower quantitative materiality threshold might be appropriate (please see our responses to questions 6a and 6b above).

Question 8

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 that these misstatements and omissions should be taken into account. Without this approach, financial reports could be issued which, overall, do not give a true and fair view of the results and financial position of the reporting entity.

Question 9a

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

We do not believe that it is appropriate for this type of information to be disclosed as an accounting policy. As noted in the CP, views about materiality can and do vary, and there is a risk that users of financial statements on which an auditor has given an unqualified opinion would assume a higher degree of agreement (or positive assurance) by an auditor on a stated policy than might be the case. For example, the auditor might use a different methodology for determining materiality, with a lack of reference to this being due to management's view

not leading to a significant misstatement for the purposes of the audit. It is also possible that the limited information that would typically be included in an accounting policy could, in the absence of a discussion of the full context of the entity's operations and the judgements involved in determining materiality, detract from rather than adding to the clarity of the financial statements. This could then lead to questions being raised about how the published accounting policy should be interpreted and applied in practice.

In our view, the focus should instead be on the judgements that have been made in applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. As noted in paragraph 20 of the CP, these disclosures might already be viewed as being required by IAS 1.122.

Question 10

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.

We do not agree that omitting required notes which give additional information about a material line item in the financial statements automatically constitutes a misstatement. Information does not need to be disclosed if it is not material.

Consequently, the focus should be on whether each component of information that is included within the disclosure requirements of IFRS is material in the context of an entity's particular circumstances and financial statements (whether individually, or in combination with other components). If the component(s) are material to the financial statements taken as a whole, then their exclusion could be regarded as being material.

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***

We believe that, in general, similar considerations apply.

However, for certain of these notes, qualitative considerations assume primary importance. For example, for narrative disclosures covering going concern considerations, a quantitative approach might not be relevant although in some cases the amount of 'headroom' in an entity's borrowing facilities could be a significant quantitative element. Other note disclosures might contain information which is sensitive (and therefore is more likely to be material) in nature, such as details of directors' remuneration or related party disclosures.

Certain other note disclosures cover risks associated with items which might not be recorded in an entity's primary financial statements, such as loan commitments. Others, such as those for concentration of credit risk in respect of trade receivables, might relate to only a portion

of a line item on a primary statement or in a note. The information included in these disclosures could be very significant, and we do not believe that the determination of whether they are material is affected by whether, or the extent to which, a related amount has been recorded in the primary statements or in the notes.

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?

It is possible that the materiality assessment could differ, because it is made in relation to the interim period financial data. As noted in IAS 34.23, greater use of estimates might be made in the measurement of interim financial information in comparison with annual financial data and materiality needs to be assessed in that context.

We note that the information presented in an interim report prepared in accordance with IAS 34 is prepared on the basis that it represents an update on the latest complete set of annual financial statements. As noted in IAS 34.6, it 'focuses on new activities, events and circumstances and does not duplicate information previously reported'. Consequently, the assessment of materiality for the purposes of the interim report may be affected by items reported in the most recent annual financial statements but this does not mean that the assessment will necessarily be the same.