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**- Your Ref: Comment letter on Consultation Paper on
Considerations of materiality in financial reporting**

Dear Sir,

Thank you for giving us the opportunity to comment on your Consultation Paper 2011/373 on Considerations of materiality in financial reporting. I will first make some general comments, and then discuss some more detailed points.

What is the nature of materiality?

Materiality is related to relevance in the sense that material information is relevant to the fair presentation of the financial position of the reporting entity. Materiality can be considered a subset of relevance, or rather, a threshold which determines whether information is relevant. It is both an entity-specific consideration, and a user-specific consideration, and therefore depends on the particular reporting entity's situation and the perceived (or stated) tolerances of users. This dual dependence does not easily permit a rules-based or uniform quantitative materiality threshold, rather a principles-based, entity- and user-specific materiality threshold.

Who should define the threshold of materiality?

Given the nature of materiality, which depends on the nature and magnitude of a particular item in relation to a particular reporting entity's situation, it demands a principles-based, entity- and user-specific consideration in order to determine its threshold. This should only

reasonably be determined by the particular individual reporting entity and its auditors before the event.¹ It can not be reasonably determined by standard-setters uniformly or in isolation. Should a question of materiality arise after the event, its implications and consequences will certainly depend on the process and due consideration given to materiality by the reporting entity and its auditors before the event.

Is there a need for more guidance in this regard?

The executive summary and introduction state that there are “apparent differing views regarding the practical application of the concept of materiality amongst preparers, auditors, possibly users of the financial reports and, in some instances, accounting enforcers”. I accept that this is the case, and would therefore welcome further guidance here.

Answers to specific questions raised by ESMA

Q1: 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?

I believe that the concept of materiality is understood by the parties. Given the entity- and user-specific nature of materiality, and its significance, it is not clear that it is consistently applied in practice. Should a question of materiality arise after the event, it may need to be settled by regulators or the courts. However, we should certainly aim to manage the expectations of all parties regarding materiality in order to minimise the number of such cases, and so additional guidance would be useful. However, such guidance should not be so specific as to pre-empt the responsibility of the individual reporting entity and its auditors to determine materiality thresholds.

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

I suggest that it would be more consistent if the accounting standard-setters, in this case the IASB, would issue additional guidance in this regard.

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.

The term ‘economic decisions made by users’ is more inclusive and complete than the term ‘decisions about providing resources to the entity’, as it allows for a greater universe of ‘decisions’ and ‘users’. For example, in terms of users it also covers analysts and reporters; in terms of decisions it also covers assessing whether management have made effective use of the resources entrusted to it.

¹ Individual users will have their own views after the event, which the reporting entity must pre-consider in its determination of the threshold.

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.

Yes. The primary user constituency should include those users with a direct or indirect economic interest in the entity. I would also add analysts and reporters to the users outlined in paragraph 16.

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.

The IASB's use of the word 'could' as opposed to 'would' clearly implies a lower materiality threshold, as you have demonstrated in paragraph 19.

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?

Yes. The expression 'reasonably be expected to' implies that a result is more likely than not to occur, whereas the word 'could' implies that the result is merely possible. The expression 'reasonably be expected to' implies a lower materiality threshold than the word 'would', and a higher materiality threshold than the word 'could'.

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.

Yes, I agree with this. Users are interested in the individual line items and their magnitude, uncertainty and trend, as well as totals.

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.

I broadly agree with the examples provided. I would suggest the following additional examples are relevant in this regard:

- *suspected persistent bias in accounting estimates;*
- *any judged shortfalls in processes in critical functions including governance, compliance, internal audit, risk management and legal (whether currently material or not).*

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.

Yes. The important point is that we should manage users' expectations concerning the nature, amount, timing and uncertainty of cash flows and the financial position of the entity. Particularly concerning netting of misstatements, I would be very concerned about large but offsetting amounts which had no impact on profit (for example) compared with smaller individual amounts which had an impact on profit.

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

I would support this entity-specific type of disclosure as long as it would not become boilerplate over time. This would help to manage users' expectations concerning materiality.

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.

I am not sure that I would always call this a misstatement, as it would depend on the circumstances, but it is clearly not acceptable.

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.

The key wording here is "significance to the overall assessment of the financial statements of the reporting entity", which implies that they could influence the economic decisions that users make. Therefore I would have to agree with (a), that the same considerations should apply as in determining the materiality applying to items which relate directly to financial statement items.

Yours faithfully

C.R.B.

Chris Barnard