

Russell C Picot
Group Chief Accounting Officer

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

13 February 2012

Dear Sirs

Considerations of materiality in financial reporting

We welcome the opportunity to provide comments on the consultation paper on 'Considerations of materiality in financial reporting' and thank ESMA for enabling us to participate in this project.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US\$2,716 billion at 30 September 2011. Headquartered in London, HSBC serves customers worldwide in 87 countries and territories in six geographical regions. HSBC provides a very broad range of financial services and products organised through four global businesses, Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking.

We note that the background to this consultation paper is that the European Enforcers Coordination Sessions have revealed apparently 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. We believe that it can be useful to discuss the concept of materiality to help ensure that there is a common understanding amongst these different constituents. However, given the subjective nature of the judgements involved, we do not believe that additional guidance would be helpful. The consultation paper raises several questions about slight differences in wording in the existing guidance and we believe adding further to the literature in this area, particularly where it would add a different perspective to the existing guidance, is more likely to confuse than assist.

Answers to the questions are set out in the appendix. We would be pleased to discuss our comments and concerns in more detail if this would be helpful.

Yours sincerely



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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?

In our experience, there is a common understanding of the concept of materiality and that requirements in the financial reporting framework do not apply when the resulting information will not influence the economic decisions of users, that is, when the information is not relevant. However, the concept of materiality can only be applied at the level of the individual entity, in the unique circumstances of the matter in question and by persons often exercising significant judgement. It seems unlikely that additional clarification could be usefully developed.

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

The concept of materiality is described in the Conceptual Framework in terms of both nature and quantity. We do not believe additional guidance is necessary

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.

Such differences in wording are unlikely to make a difference to how the concept of materiality is applied since the individual circumstances and context, including the nature and size of the item, will be considered by those exercising their judgement. This is particularly the case when materiality decisions involve information related to corporate governance. While some may consider that resource decisions do not include matters of corporate governance, for example, voting for the re-appointment of directors, it is also not clear that such a decision is purely economic.

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.

Under UK company law, financial statements are prepared for shareholders, who are the owners of the company. Accounting frameworks, including the IFRS Conceptual Framework, extend this group of primary users to others with an existing or potential equity or debt relationship with the company who will have very similar interests to owners. While others may also have an interest in the financial performance and position of the company, in preparing financial statements and exercising materiality judgements, it is important to bear in mind this group of primary users and the notion of general purpose financial statements. It can be challenging to consider what could influence the economic decisions of primary users, to try to extend this concept to undefined decisions by a wider and more disparate group of users would be untenable.

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.

Since materiality must be considered in context and is not merely a numerical threshold, we do not necessarily agree that the use of a particular word implies a lower materiality threshold. Those making a materiality judgement in practice would not make such a fine distinction.

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?

The inclusion of the expression 'reasonable be expected to' merely makes explicit that auditors and preparers are both exercising professional judgement. In practice, if their judgements are not aligned, this will be reflected by some modification to the audit opinion.

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.

An analysis of the materiality of an item will be undertaken within the context of the item in question which may include both profit for the period, statement of financial position totals and other relevant information, including individual line items, trends, ratios and disclosures.

Q6b: Do you agree that each of the examples provided 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.

The list is intended to include examples where materiality judgements are particularly sensitive. We believe in such circumstances, the context of the item should be carefully considered, including both its size and its nature. Therefore, we do not necessarily agree that the examples represent instances where the quantitative materiality threshold may be lower. This is particularly important when legal or regulatory breaches or transactions with related parties are involved, when qualitative factors may be more relevant to the judgements involved than size alone.

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.

In practice, all significant misstatements and omissions are considered in their context. In addition, errors and omissions which are “clearly trifling” may not be considered further.

Q8: 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 above in determining materiality? Please explain your views in this regard and provide practical examples, if applicable.

We agree that preparers assess whether identified errors, omissions and misstatements should be corrected in their wider context and this will include the considerations in paragraphs 24 to 27 to the extent they are relevant to the circumstances. As noted above, items which are “clearly trifling” are unlikely to be included in the assessment. We also note that, the preparation of financial reports that can be complex, lengthy and subject to challenging deadlines. Therefore a further consideration in making such judgements can be the risk of inadvertently introducing additional misstatements in the process of making corrections.

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.

No. This would be a tautology. Financial information is only useful where it is relevant to users, that is, where it is capable of making a difference in their decisions. Where an item is material, it will be considered to be relevant in the context of the specific entity and will be recognised, measured, presented and disclosed in accordance with the requirements of the accounting framework, including disclosure of the relevant accounting policies and significant judgements. Where an item is not material, disclosure cannot make it relevant.

In other words, materiality judgements are widely pervasive in the preparation of financial statements and take place at all levels, from determining the structure and format of the primary financial statements, determining the level of review and challenge of different items of income or expenditure, drafting descriptions of contingent liabilities, to deciding whether discovered errors should be corrected. It would not be possible to aggregate or otherwise provide information about all these different judgements in a manner which would be useful. A policy for making materiality judgements would merely repeat the existing guidance.

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.

Not necessarily. The presentation in the primary financial statements and in the notes should aim to provide the information that is relevant to the users’ understanding in the

circumstances of the business and the industry. There is a balance to be struck between including additional line items, combining similar line items and providing further analysis in the notes. In addition, accounting requirements may contain many additional disclosures which may or not be material in different circumstances. Therefore it is possible for a line item to be material but not necessarily for all the detailed disclosure requirements to be material. An absolute rule that all note disclosures are always required for a material line item is reflective of a tick box approach to the production of financial statements, which can be incompatible with meeting the overall objectives of financial reporting.

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 same concept of materiality should be applied to all the judgements involved in preparing financial statements. However, the concept of materiality can only be applied in the context of the circumstances of the matter in question. Significant judgement may be needed from those who acting to determine what they think would influence the economic decisions of a third party user of the financial statements. Therefore, while the same considerations apply, these may result in different quantitative and qualitative characteristics being considered more important in different circumstances. For example, different materiality judgement may be made in relation to disclosures concerning amounts that are not recognised in the financial statements than to amounts that have a significant impact on the recognised profit for the period. It is reasonable to conclude that a user's economic decisions, like those of the managers of the business, are more affected by values recognised in the financial statements than values that are merely disclosed.

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?

A materiality assessment will consider the quantum and nature of the items involved in the context of the situation. At an interim period, the amounts involved may be smaller than for the full year, although this may not be the case for significant, one off transactions. An interim period should also be considered as an update from the previous full year which would tend to put more emphasis on reporting differences from the previous full year and new items rather than just repeating the same information.