The Corporate Reporting Users' Forum

European Securities and Markets Authority
Submitted online: www.esma.europa.eu

30th March 2012

Dear Sir

The CRUF welcomes the opportunity to comment on ESMA's interesting discussion document on materiality.

We believe that materiality is a crucially important issue. There have been various projects in recent years regarding the level and nature of disclosure in corporate accounts, displaying a general concern about the current position. As users of accounts we are frequently frustrated to see useful – and material – pieces of information buried in a slew of data which is not material and which should not be disclosed; equally, we are frustrated when we find that information which is material to an understanding of a company's performance and status is not disclosed at all. The ESMA initiative also appears to be geared only towards ensuring full reporting of all material items. Emphasis should also be placed on ridding reporting of non-material "noise" in the financial statements and notes.

We believe that there needs to be more clarity regarding materiality, and more confidence among boards in applying the logic which materiality requires. In order for this to happen, we believe that there needs to be a full debate of the issue, with active involvement from the IASB and IAASB with regard to IFRS which will have important insights and an important influence on what form materiality takes into the future. We strongly welcome this ESMA paper as the formal start of such a debate; but it will be apparent from our desire for a full scale debate on the issue that we do not believe that ESMA should close off this debate by attempting to set standards. As the IFRS is a multinational standard, we believe that the debate needs to include all regions affected and result in a ruling by the relevant standard-setters, rather than seeing it end with regional standards.

We answer the specific questions below.

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 do not believe that the concept is clearly and consistently understood, and we believe that the reporting we currently use frequently fails to hit the appropriate balance of materiality. We would welcome consistency between accounting and auditing standards, but firmly believe that this cannot be done through arbitrary numerical definitions, and must only be done on the basis of clear principles to be applied with judgement by directors (and if necessary challenged on the same basis of principles by the auditor).

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Q2: Do you think ESMA should issue guidance in this regard?
No. We welcome ESMA's role in opening the debate on this important issue but we do not believe that it is appropriate for ESMA to issue guidance on this. The issue should be addressed within the relevant accounting/reporting framework – i.e. by IASB and IAASB for IFRS - not regionally, and it needs a good deal more public discussion and debate before any standards are set. Additionally the ESMA as we understand it was created as a result of the financial crisis and with a particular remit with regards to financial institutions. Standards of this sort would have an overarching effect on all industries and not just financial institutions, which again suggests that the issue should be addressed by a body with overreaching standard-setting responsibilities.

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.
No. We are firmly of the view that there are a class of economic decisions made by users which are not decisions about providing resources to the company. Typically talked of as stewardship decisions, the importance of these lies in calling management and boards to account for their delivery of value from the assets with which they are charged. These decisions are of crucial economic value to users, helping them enhance the returns from companies in which they invest, but they are not decisions whether or not to provide resources to those companies.

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.
We believe that the list in paragraph 16 is a good reflection of the IASB definition, and certainly we would expect all of the needs outlined in the list to be material factors in judging what information needs to be disclosed; though we are keen to ensure that the IASB definition is not expanded in any piecemeal fashion. Also, as noted in our response to Question 3, we do not believe that this list is complete as it excludes the important class of decisions made by primary users regarding stewardship issues which are also based on the financial statements. For example, it is not enough to know whether a company can afford proposed remuneration, it is also necessary for investors to understand why that remuneration is appropriate; investors carrying out their stewardship role also need a close awareness of the efficiency with which the company uses its assets such that they can assess whether the management and board are carrying out their roles effectively.

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.
We agree that 'could' potentially sets a lower threshold of materiality than 'would'. We believe that 'could' is indeed the proper threshold for these purposes as it does not require a certainty that this information will always be centrally useful to decision-making, just that it is important information which may on occasions - or for certain users or particular purposes - be relevant to economic decision-making.

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 believe that the auditing standard statement of materiality as 'could reasonably be expected to' is the same as the accounting standard 'could'; it is simply an amplification of the term 'could' so that it is clear that only rational understandings of what is material need to be taken account of. Unreasonable assumptions of what could be necessary for users can be dismissed. We thus do not believe that there should be conflicting interpretations of materiality arising out of these different phrasings in accounting and auditing standards.

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 we firmly agree that using simply a quantitative analysis compared to one (or more) headline number is wholly inappropriate. We believe that it is necessary for the directors to make a judgement as to materiality, and for this to be actively tested by the auditors, in relation to different line items. We welcome ESMA's discussion of this need for judgement in paragraphs 21 and 22.

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.
Yes, we agree that the examples provided would all require a significantly lower materiality threshold.

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 we believe that misstatements and omissions need to be considered carefully in relation to questions of materiality. Misstatements and omissions, even historic ones, are of particular importance to users because they raise questions not just about the current reported numbers but about the confidence that users can have in the future performance of the business. They thus need to be discussed with some care and detail.

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.

Yes we believe that the materiality judgements in this respect are of particular importance. These disclosures need to be made to users as this is one crucial way in which the audit committee can make clear its effective oversight of key judgements within the accounting. It is debatable whether these disclosures should be made as part of the notes to the accounts - they may better form part of a richer report from the audit committee to shareholders about the decision-making of the audit committee and the key accounting judgements taken in the reporting process, including the committee's oversight of those judgements.

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.
We agree with the thrust of ESMA's argument: that if a line item is material, then disclosure notes in relation to that line item must also be necessary in order for users to understand that line item and what underlying performance has created it, however we would still expect both the directors and the auditors to exercise their judgement on the materiality of each of the components of the notes so that the accounts are not overburdened by data which is only of minimal relevance.

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 believe that the same principles on materiality need to be applied to all judgements on the issue. Again we would expect the directors to exercise appropriate judgement as to materiality and the auditors to provide the necessary challenge to those judgements.

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 believe that the same standards of materiality need to be applied to interim reports as to annual statements.

About the Corporate Reporting Users' Forum (CRUF)
The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve

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consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

Paul Lee
Director
Hermes Investment Management Ltd

Michael McKersie
Assistant Director, Capital Markets
Association of British Insurers

Norbert Barth
Executive Director
WestLB AG

Terri Campbell, CFA

Peter Elwin

John Kattar CFA,
President and Chief Investment Officer
Eastern Investment Advisors

Greg Marks
Senior Portfolio Manager
Wallara Asset Management Pty Ltd

Robert Morgan

Scott A. Nammacher

Ian Rossa O'Reilly
CFA , Director
Toronto CFA Society

Chris Pidcock
Managing Director
Equity Strategist
Goldman Sachs JB Were

Kim Shannon
President & CIO
Sionna Investment Managers Inc.

Pinto Suri
Flaherty & Crumrine

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Lothar Weniger

Jed Wrigley
Portfolio Manager
Director Accounting and Valuations
Fidelity Worldwide Investments