



Steven Maijoor
Chairman
ESMA
103 rue de Grenelle
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30 March 2012

Dear Sir:

ESMA Consultation Paper: Considerations of materiality in financial reporting

We appreciate the opportunity to comment on the European Securities and Markets Authority (ESMA) Consultation Paper – Considerations of materiality in financial reporting.

This response summarises the views of the PwC member firms who commented on this consultation paper. “PwC” refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

The application of materiality involves significant quantitative and qualitative judgement, based on the applicable facts and circumstances of the intended use of the financial statements and related disclosures. The concept of materiality relates to the information needs of users of the financial statements, who require information important to their decision making. We have considered the Consultation Paper in the context of financial statements prepared for use by investors in the capital markets.

We believe the current guidance provided in the IASB Framework and accounting and auditing standards, issued by the IASB and the IAASB respectively, to be sufficient in most respects. However, in the interest of continuous improvement we are supportive of further dialogue aimed at minimising the potential differences in how materiality is considered across territories, where such dialogue balances the views of all stakeholders. We support the consultation and dialogue initiated by the IAASB in this regard¹ and also the IASB moving forward with the development of a disclosure framework as part of its agenda. If, as a result of these efforts, a consensus emerges for the development of new guidance on materiality, we believe such guidance should be principles, rather than compliance or rules, based.

We note that a number of initiatives have also been launched by regional or national regulatory and professional bodies in recent years focused on aspects of materiality, particularly with respect to financial statement disclosures. The concept of materiality is of course integral to both the preparation and auditing of financial statements, and where the standards being applied are

¹ IAASB Discussion Paper – The evolving nature of financial reporting: Disclosure and its audit implications.

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international, the application of the concept of materiality in those standards should reflect the views of all territories impacted.

Accordingly, while we are supportive of ESMA's input into these considerations, we believe it would be more appropriate for the development or refinement of guidance in respect of the application of materiality to the preparation and audit of financial statements prepared under IFRS to be addressed by the IASB, and where relevant the IAASB, rather than by ESMA.

We have included in Appendix A responses to the specific questions raised in the Consultation Paper.

We would be pleased to discuss our views further with you. If you have any questions regarding this letter, please contact Diana Hillier (+44 207 804 0472), John Hitchins (+44 207 804 2497), Tom Quinn (+44 20 7804 2196) or Jamie Shannon (+44 141 355 4225).

Yours sincerely,

A handwritten signature in black ink that reads 'PricewaterhouseCoopers LLP'. The signature is written in a cursive, flowing style.

PricewaterhouseCoopers LLP

APPENDIX A

Comment Analysis

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 believe the concept of materiality is reasonably understood by these stakeholders, but greater consensus might emerge from further dialogue that would enhance consistent interpretation and application of the concept and appreciation of the different perspectives of stakeholders across territories.

Trends in financial reporting have undoubtedly increased both the complexity of financial statement disclosures and the importance of their role in the fair presentation of the financial statements. More widespread use of fair values and the recognition in the financial statements of estimates with greater measurement uncertainty often warrant more disclosures of assumptions, valuation models, and sensitivity analyses. Given these trends, it is appropriate for various stakeholders of corporate reporting to be examining whether changes are needed in how financial reporting and auditing concepts, including materiality, are applied.

We believe that users and regulators might benefit from additional consideration and dialogue regarding the qualitative aspects of materiality and its application to increasingly subjective and imprecise information inherent in current financial reporting. We continue to believe that the IASB's development of a disclosure framework would serve a valuable role in providing context to the judgements that need to be made by management and auditors with respect to the materiality and relevance of the disclosures in the context of the fair presentation of an entity's financial statements.

To the extent consensus emerges that further clarification would be useful, it should be recognised that new requirements or guidance in accounting and auditing standards alone will not address consistent application and understanding across the range of impacted stakeholders. Regulators' views and actions will influence judgements and behaviours, as well as how materiality principles and standards are interpreted and applied in courts of law. Therefore, greater understanding and consistent application can only be achieved through collaboration across territories between management, those charged with governance, investors, auditors, regulators and accounting standard setters. Without all stakeholders being engaged in this dialogue, it will be difficult to forge a broad consensus as to how materiality judgements are made in practice.

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

We do not believe that a national or regional regulator is the appropriate body to issue guidance on the concept of materiality given that the accounting and auditing standards to which such guidance would apply have global application. Rather, in the event consensus for additional guidance emerges from further dialogue, such guidance should be developed by the IASB in concert with the IAASB. We are concerned that adopting a regional or national approach to developing additional guidance applicable to financial statements prepared in accordance with IFRS could result in less, rather than more, consistent application across the territories that apply these international standards.

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.

We consider that the term ‘economic decisions made by users’ represents a broader concept than ‘decisions about providing resources to the entity’. Economic decisions encompass ‘decisions about providing resources to the entity’, but not every user will necessarily be considering whether to provide resources to an entity.

Economic decisions of investors are fundamentally about whether to invest resources directly in an entity or to acquire or sell economic interests of an entity that may be held by others. However, the IASB Framework indicates that for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs should also meet most of the needs of other users that financial statements can satisfy.

As clarified in ISA 320, judgments about matters that would be material to users of the financial statements are based on the common financial information needs of the users as a group. The possible effect of misstatements on specific individual users, or a distinct sub-group of users is not considered individually.

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 15 above? Please explain your rationale and if possible provide further examples.

We consider that the users outlined in paragraph 15 of the consultation represents ‘interested parties’. However, from an audit perspective these are not necessarily the “primary users”.

Paragraph 13 defines primary users as “*existing and potential investors, lenders and other creditors*”. In our opinion the category “other creditors” encompasses a variety of different stakeholders, such as past and present employees, government agencies (including tax authorities) and trade creditors.

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.

Where IFRS is applied today, we consider that this is largely a matter of semantics, rather than necessarily implying that a lower threshold exists. We consider use of the word ‘could’ as simply reflecting the fact that materiality is a judgement and, as such, what might be material to one user may not be considered material by another. We do not consider that matters ‘would’ definitively be material, in a wide variety of situations.



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 don’t believe that this expression should lead to a different assessment. We consider that the term ‘reasonably be expected to’ simply provides a further benchmark for assessing what is truly material. In principle the different terms should lead to the same assessments as they target the same group of users. While it is possible that different terminology might lead to different interpretations, we have not seen significant instances of this in practice.

An assessment of materiality should take into account the information needs of users. This will always be a matter of judgment. We believe that this assessment is driven by what could reasonably be expected to influence the user’s decision making.

However, we acknowledge that there is merit in the IAASB and IASB endeavoring to better align the definitions, terminology and application of materiality between IFRSs and ISAs.

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.

Both qualitative characteristics and the needs of users must undoubtedly be taken into consideration when evaluating whether an identified quantitative misstatement is material or not. Indeed, certain narrative or qualitative statements cannot be assessed on a quantitative basis.

The assessment of the impact of a matter on the related financial statement line item, disclosure or classes of transaction is an important consideration in relation to, for example, matters or line items that might be more sensitive to users of the financial statements. On the other hand, not all disclosures relating to significant financial statement line items are necessarily material by definition; this will depend on the specific facts and circumstances. In both cases, judgments are made in the context of their perceived impact on financial statements as a whole.

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 nature of a matter can often be such that, regardless of the magnitude of the ‘number’, the disclosure of that matter might be considered material to the intended users. Materiality for these types of transactions/balances should be determined using professional judgment. A conclusion on materiality will depend on the nature of the transaction or balance, and also the relative amount compared to other items in the primary financial statements. We believe this is a qualitative aspect of materiality. Other examples may include misstatements or omissions that (i) reflect a misclassification between particular account balances (for example, between operating or non-operating income) or (ii) conceal technical insolvency or going concern problems or could affect the entity’s distributable profits and hence the ability to pay dividends.



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.

We believe that preparers should assess the impact of all known misstatements and omissions. There may be situations in which larger uncorrected misstatements may be acceptable. Conversely, there may be situations in which smaller uncorrected amounts when aggregated may be material, for example, when they have the effect of changing a loss into a profit or of bringing the entity's financial statements into compliance with a covenant in a loan agreement that would otherwise be violated.

Errors which are initially insignificant may become material in subsequent years. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements if corrected. We note that the US Securities and Exchange Commission considered this area previously and issued guidance regarding how such prior period unadjusted errors should be addressed, and we consider that guidance in this area might be useful.

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.

As noted previously, we believe that preparers should assess the impact of all known misstatements and omissions. Materiality is based on the information needs of users. When materiality has been determined and misstatements and/or omissions have been noted, we believe those should be corrected unless the impact on current reporting and potential impact on future reporting is not considered to be material to users.

We believe the misstatements and omissions as referred to in paragraphs 24 to 27 are in a sense a checklist of potential considerations, rather than a principle-based approach to what should be considered. We consider that a principle-based approach would be much more useful in practice.

Q9) Do you believe that an accounting policy disclosing the materiality judgments exercised by preparers should be provided in the financial statements? If so, please provide an outline of the nature of such disclosures. In either case, please explain your rationale in this regard.

We do not believe such disclosure should be required. As noted previously, we believe that the concept of materiality is reasonably understood. We also consider that such a requirement would result in "boiler plate" type disclosures being added to already lengthy financial statements.

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.

Omitting required information on material line items is usually considered to be a misstatement if it is material to a user's understanding of the line item. Such information is generally presumed to be relevant to users and indeed this is the basis of the generic requirement, but a determination of its



materiality would depend on the quantitative and qualitative characteristics of the information and the user's needs in each circumstance.

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.**

In general, the same materiality considerations apply as for primary financial statement items, that being: what information is relevant for the users of the financial statements? As this information is often difficult to quantify, qualitative aspects are of importance.

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?

For interim financial reports, materiality should be assessed in relation to the interim period financial data being reported, as required by IAS34. One would generally apply similar quantitative and qualitative judgements as for the annual financial statements, in the context the condensed level of information provided under IAS34.

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