

Considerations of Materiality in Financial Reporting

The ABI's response to ESMA's consultation paper

Introduction

1. The Association of British Insurers (ABI) is pleased to have the opportunity to respond to ESMA's invitation to comment on its consultation paper on materiality in financial reporting.
2. The ABI represents the UK's insurance, investment and long-term savings industry, the largest in Europe and the third largest in the world. It has over 300 members, accounting for some 90% of premiums in the UK domestic market and manages investments of £1.5 trillion. We have a strong interest in ensuring that financial reporting addresses the information needs of investors and other users of accounts and provides a true and fair view of the performance and financial condition of the entity. What is material to users is accordingly critical to ensuring that accounts achieve these objectives.

General comments

3. The publication of this document demonstrates ESMA's recognition of the importance of materiality to financial reporting in Europe being of a high quality and conducted in accordance with relevant standards. In practice these standards, particularly in accounting through IFRS as developed by the IASB and adopted in the EU, but also in auditing under ISAs as promulgated via IAASB, are global in nature. Accordingly it is at global, not European, level that the actual determination or interpretation of what those standards requires should take place. Nevertheless we think the current consultation is a useful means through which European views can be distilled and in turn used to inform debate at global level.
4. We emphasise the importance of materiality in reporting to shareholders and to other providers of resources to reporting entities. This requires the application of judgment not just to financial statements as a whole but to individual areas, and we stress that this cannot be based on simple uniform quantitative measures. What matters to users is that disclosures are made that are material to decisions that they make on the basis of the accounts, and that the disclosures taken as a whole ensure that a true and fair view is conveyed.
5. We agree that disclosures can present particular difficulties in applying that judgment, and we agree that there is likely to be variability in practice as a result. We suggest that this gives rise to risks not just of insufficient information but also of excessive information that serves to obscure. There has, in general, been a growth in concerns among both users and preparers that expansion of disclosure requirements has led to a loss of focus on key issues and an increase in box-ticking

compliance and a consequent need, as identified by the UK's FRC, to 'cut the clutter'.

6. We support a number of current initiatives that may help in this respect, including IASB's post-implementation review programme and EFRAG's project to develop principles to guide disclosures requirements in IFRS. We encourage ESMA's contributions and those of national capital markets regulators in the EU to these developments so as to ensure that shareholders and other suppliers of capital are given the information they need.
7. As regards financial reporting by regulated financial entities users, the financial metrics applied by regulators will also be of relevance to investors and other primary users and appropriate disclosure of relevant data is therefore necessary for a full understanding of the position and prospects of the entity. We stress, though, that the primary objective of financial reporting still relates to the information needs of investors, lenders and other creditors and not with the needs of regulators, nor to provide a presentation or treatment which suits regulatory objectives. Regulatory capital reporting is supplemental to and not in substitution for financial reporting in accordance with the established objectives laid down under the IFRS framework.

Questions for consultation

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?

The concept is probably not as clearly understood as it might be and in practice we believe is not applied in a consistent manner. It would clearly be desirable to achieve as much congruence as possible between how this is treated in accounting and auditing frameworks but this needs to rely on clear principles and not on arbitrary numerical definitions. We see greater potential for it in relation to auditing, because there is no common auditing framework in the EU. In relation to IFRS, we suggest that, given that the IASB already has a concept of materiality, the IASB be encouraged to consider during the course of post-implementation guidance whether extra guidance should be given in specific areas in order to achieve consistency. The results of regulatory reviews of auditors' practices and of companies' accounts might also help to identify the potential need for such extra guidance.

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

We do not think ESMA is best placed to issue guidance except in so far as this is necessary to achieve compliance with EU-sourced requirements which we would expect to be applied sparingly. The IASB is the body responsible for issuing any additional guidance that might be required in respect of the application of its own standards.

We note that the consultation paper makes extensive cross-reference to publications of these international bodies responsible for accounting and auditing standards but no reference is made to the EU law in compliance with which financial reporting in EU Member States is undertaken. Clearly ESMA should be concerned if, for example, the requirements of EU law in this regard were not being fully satisfied through international standards on accounting or auditing. However, this is not what the paper appears to be addressing. It might have been helpful if the paper had explored this legal backdrop.

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 also consider that two distinctions are needed here. The first is within the IASB's 'primary users of financial statements' category. The second is between the IASB's category of primary users on the one hand, and on the other hand, any other parties that may also find general purpose financial statements useful.

Within the IASB's category of primary users, we consider that economic decisions made by investors in their capacity as shareholders of the entity extend beyond resource allocation decisions made by other providers of economic resources to the entity; for example, from a stewardship perspective in discharging their responsibilities as owners. We welcome the fact that the IASB and IFRS

Foundation have in recent times shown somewhat greater recognition of the stewardship dimension than they have hitherto.

Otherwise, we agree with the IASB's distinction between primary users and other users. For example, we note that regulators normally have powers to obtain the information they need from regulated entities, and so they need not rely on financial statements.

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.

The IASB's inclusion of potential investors, lenders and creditors is an extension beyond what we would see as the central audience of financial reporting in the first instance i.e. the shareholders of the company, but as a sensible one in the context of the requirements of the financial markets and their users. If accounts provide a true and fair view to them they will be of value to other users but we do not view the present and past employees of the company as being a sub-set of the group of primary users as defined, because the decisions that they make are different from those of the IASB's primary users. The ability of the entity to provide remuneration and retirement benefits, identified in Paragraph 16 (c) is in fact of relevance to primary users. Present and past employees, or indeed their representatives such as the trustees of a pension scheme, may make use of such information though they may well have access to, and make use of, other sources of financial information beyond that presented in general purpose financial reporting.

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.

Yes, and quite rightly this suggests that the entity should err on the side of providing the information rather than not, given that they cannot know for certain the circumstances and requirements of all potential users.

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 it might, and it probably raises the materiality threshold. This formulation has merit in focusing on the reasonable requirements of users but we do think it would be important to ensure that information could reasonably be expected to be of relevance to at least a significant minority of users, and especially where the information would be relevant to diligent users of accounts, such as institutional investors, whose assessments would be important to price-formation processes in the market.

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.

We agree. The significance of an item cannot be assessed solely by reference to its quantitative effect on primary statement totals, nor indeed will a single quantitative measure be appropriate in assessing the materiality of all individual line items.

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. Some of these instances justify a lower materiality threshold because of their relevance for economic decision making by investors or other users while others have important implications from a 'stewardship' perspective.

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.

Yes, and we think this is necessary in order to comply with IFRS requirements..

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 agree, for the reasons advanced in the consultation paper, and we consider that IFRS requires that these steps be taken.

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.

Disclosures around materiality judgments exercised by preparers are helpful to users though we do not agree with disclosure as an accounting policy. Quality narrative reporting, including through reporting by audit committees or perhaps auditors, could be the best means of providing this information to users, together with, where appropriate, risk-based sensitivity analysis.

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 that it may do so, in line with ISA 450's stipulation that "When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the

auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view". We note that this does not require immaterial disclosures, even in relation to material line items.

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 principles should apply within an overall obligation on the financial statements and disclosures as a whole to provide a true and fair view. In cases of doubt we consider that disclosures should be made.

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 consider that the underlying principle of relevance to users applies to both interim and annual financial reports. However, neither the accounting nor the auditing requirements are the same for both, and the application of the principle may not achieve the same results. Nevertheless, interim reports provide information in the period between the publication of annual accounts giving a true and fair view for the previous period and that for the current period, and consistency is required for accounting policies, and for the recognition and measurement of profit and loss items.

ABI
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