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March 9, 2012

Mr. Steven Maijoor
Chair
European Securities and Markets Authority
(ESMA)
103 Rue de Grenelle
75007 Paris
FRANCE

Submitted online :
www.esma.europa.eu/Consultations

Dear Mr. Maijoor,

**Re.: ESMA Consultation Paper: Considerations of Materiality in
Financial Reporting**

We would like to thank you for the opportunity to provide the European Securities and Markets Authority (ESMA) with our comments on the Consultation Paper "Considerations of Materiality in Financial Reporting" (hereinafter referred to as the "paper").

We would like to welcome ESMA's initiative to address the issue of materiality, which is central to financial reporting. We believe it to be important that preparers, auditors, users, financial reporting enforcement authorities, and regulators, have a common understanding of materiality because differences in understanding among these groups would lead to miscommunication in financial reporting and thereby diminish the value of financial reporting to users and cause friction among the parties.

However, our appreciation for ESMA placing this issue on the European agenda should not be interpreted as welcoming further regulation by other than the International Accounting Standards Board (IASB) in this regard. We do not believe it to be appropriate for ESMA to develop requirements, standards or

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page 2/13 to the comment letter to ESMA dated March 9, 2012

guidance in relation to materiality: this is the IASB's responsibility. Rather, we believe ESMA should play a role in facilitating the IASB in providing further requirements and guidance in this respect.

While there is no empirical evidence that there is a lack of a common understanding of materiality among preparers, auditors, users, financial reporting oversight authorities, and regulators, the fact that the wording of the guidance is different in the IFRS and the ISAs suggests that there may be some differences in understanding. For this reason, we believe it would be appropriate for financial reporting standards setters to provide further requirements and guidance on the concept and application of materiality for preparers and thereby help consistent understanding of the concept among the other parties. The fact that such requirements and guidance may be difficult to develop is not an excuse for the IASB to not tackle the issue. Indeed the International Auditing and Assurance Standards Setting Board (IAASB), as the international standards setter for auditing standards, has provided considerable additional guidance in relation to materiality.

In this respect, we would like to point out that – as currently recognized by IFRS and other financial reporting standards as well as other accounting literature – materiality is a financial reporting concept that is user-driven – i.e., it is user needs that determine what materiality is. **Consequently, by definition, materiality for the presentation of financial statements by preparers, and for auditors, financial reporting enforcement authorities and regulators, cannot be different than materiality for users.** Materiality is a preparer, auditing, enforcement and regulatory issue because it is a financial reporting issue for users: materiality is not a preparer, auditing, oversight or regulatory issue on its own.

However, this does not mean that additional concepts similar to, or based on, materiality are not required by, for example, preparers and auditors. Preparers are not only responsible for preparing financial statements that are presented free of material misstatement, but are also responsible for:

- safeguarding assets of the entity,
- the efficiency and effectiveness of operations, and
- compliance with law and regulation.

Consequently, to safeguard assets (e.g., booking small transactions leading to assets and liabilities), ensure the efficiency and effectiveness of operations (e.g., establishing controls over business processes and the achievement of management targets), and comply with law and regulation (e.g., calculate taxes,

page 3/13 to the comment letter to ESMA dated March 9, 2012

excises, and public fees), preparers must apply thresholds that are often significantly lower than the materiality applicable to the presentation of the financial statements. However, in these cases, the costs and benefits of applying the thresholds determine the appropriate thresholds, rather than users' needs.

Auditors need to take into account the aggregation risk of unidentified misstatements when auditing financial statements, which means that, based on materiality, auditors apply a threshold lower than materiality known as "performance materiality" (see ISA 320) when designing and performing audit procedures.

Nevertheless, aside from these other thresholds used by preparers and auditors, materiality from users' perspective must be the same as that applied by preparers, auditors, financial reporting enforcement authorities, and regulators in relation to the presentation of the financial statements.

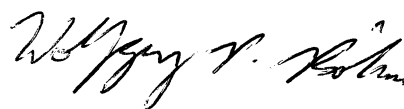
One matter that does not appear to be addressed in the IFRS is the trade-off between the comprehensiveness of financial statements (particularly in relation to disclosures) and their comprehensibility for users. If the notes to the financial statements are cluttered with voluminous immaterial disclosures, the understandability of those financial statements suffers. The question arises as to at what point the understandability is so impaired that the financial statements no longer provide a fair presentation. The IASB may need to give consideration to requirements derived from the need for understandability to help rationalize the extent of immaterial disclosures.

We hope that our views will be helpful to ESMA in its deliberations about regulatory policy for financial reporting. If you have any questions relating to our comments in this letter, we would be pleased to be of further assistance.

Yours sincerely,



Klaus-Peter Feld
Executive Director



Wolfgang P. Böhm
Director, International Affairs

APPENDIX:

Responses to Questions Posed in the Consultation Paper

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?

Even though the concept of materiality is defined in IFRS and there is no empirical evidence that the concept of materiality is understood differently by different parties in the financial reporting supply chain, the concept is described differently by IFRS and auditing standards, and this may cause the concept to be differently. Therefore we acknowledge the understanding and application of this concept may differ in practice among preparers, auditors, users of financial statements as well as financial reporting enforcement authorities and regulators. In particular, because of the lack of sufficient guidance in IFRS, auditing standards setters (such as the IAASB) have found it necessary to provide additional guidance on the issue to auditors. This may also engender a difference in understanding of the concept between preparers and auditors, and between these parties and enforcement authorities and regulators.

Materiality is currently defined within IFRS as an entity-specific aspect of relevance based on the nature or magnitude, or both, of items to which the information relates. Therefore, the financial reporting standard setter cannot specify a uniform threshold for materiality. Consequently, materiality is subject to judgement. However, auditing standards setters do provide more guidance on how to determine quantitative materiality (see ISA 320), and considerable auditing application guidance is given in other literature, including on different appropriate bases and ranges of percentages for quantitative materiality (see the IFAC SMP Audit Guide). Some of this guidance would be useful for preparers in presenting financial statements too.

page 5/13 to the comment letter to ESMA dated March 9, 2012

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

Since the concept of materiality in IFRS is a global one and impacts the work of both accounting and auditing profession around the world, we would not support having ESMA issue guidance on materiality: the fact that ESMA is a European authority, such guidance would become a European variation, when the main aim ought to be to develop global approach for financial reporting. Furthermore, securities regulators should not be engaging in standards setting for financial reporting: this is the responsibility of financial reporting standards setters.

Therefore, we believe that the issue of inconsistent understanding and application of materiality in IFRS should be addressed by at a global level by the IASB. Since the IAASB, as the international auditing standards setter, and other auditing literature, have further guidance on the matter, the IASB may be able to draw upon the work by the IAASB and this other literature.

In this respect, the IASB should consider a project on materiality as part of its Framework Project in the first instance. Furthermore, additional guidance could be provided by the IFRS Interpretations Committee. In particular, the IASB ought to consider dealing with quantitative materiality issues in relation to the primary financial statements and also disclosures.

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 believe that the main objective of general purpose financial reporting is to enable the users to make informed economic decisions, which includes providing resources to the entity. There are, however, economic decisions that do not relate to the provision of resources to an entity. For example, a customer may make the economic decision about the financial resources of a potential supplier before choosing that supplier: this is an economic decision, but the customer is not providing resources to the entity.

Consequently, the concept of “economic decisions made by users” is a broader concept than “decisions about providing resources to the entity”.

page 6/13 to the comment letter to ESMA dated March 9, 2012

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.

Primary users of general purpose financial statements are defined in the IASB Conceptual Framework for Financial Reporting as existing and potential investors, lenders and other creditors making decisions about providing resources to the entity. However, it should be recognized that the corollary of this definition is that users that make economic decisions that do not involve making decisions about providing resources to the entity are then not considered primary users of general purpose financial statements. The IASB recognizes that investors and creditors also have an interest in the stewardship objective of financial reporting.

We recognize that there are numerous stakeholders other than primary users interested in the financial statements. Nevertheless, we believe this fact is not really relevant to the discussion on consistent application of the materiality concept, if one assumes that financial statements are prepared to satisfy the information needs of the primary users.

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 use of the word "could" implies a bare possibility of a misstatement, including omissions, influencing economic decisions of users, whereas the use of the word "would" implies that there is virtual certainty that a misstatement, including omissions, influences economic decisions of users, when such a misstatement exists (i.e., "would" is used in a conditional sense). All other things being equal, it is correct that the word "could" involves a lower threshold for materiality than "would", because lower thresholds of materiality have a bare possibility of influencing users than thresholds of materiality that are virtually certain to influence users.

Those that were party to the discussions at the IAASB at the time ISA 320 was developed point out that the reason why the IAASB used the term "could reasonably be expected to" in its description (not definition) of how financial reporting frameworks generally describe materiality is because there was a disconnect between IFRS and US GAAP on this

page 7/13 to the comment letter to ESMA dated March 9, 2012

issue at the time. Under FASB's Statement of Financial Accounting Concept No. 2, the analogous words were "makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced." Most IAASB members believed that the use of the word "could" implied too low a threshold, but did not believe it to be appropriate to use the probabilistic term "probable", which suggests a degree of mathematical accuracy, rather than the application of judgment. On the other hand, a significant number of IAASB members wished to retain the word "could", as it is used in the IFRS definition. Furthermore, the definition of materiality in IAS 1 contains the following guidance:

"Therefore, the assessment needs to take into account how users with such attributes *could reasonably be expected* [italics added] to be influenced in making economic decisions"

For this reason, a compromise was reached in the IAASB to retain the word "could", but to clarify that a bare possibility is not meant by adding the words "reasonably be expected to" from the guidance to the definition in IAS 1. Technically speaking, this combines two thresholds ("could" and "reasonably be expected to"), which makes the effect of the combined threshold ambiguous.

Since then, the IASB and FASB both use the word "could" in their conceptual frameworks. However, the question remains whether this is, in fact, the appropriate risk threshold. It can be argued that one reason why voluminous disclosures are considered necessary by preparers, auditors and users under IFRS and US GAAP is the fact that the word "could" implies such a low threshold for materiality – particularly for qualitative materiality. At a technical level, it would be preferable if the definition of materiality under IFRS and US GAAP (and its description in ISA 320) were to read as follows:

"Misstatements, including omissions, are considered to be material if they, individually or in aggregate, are reasonably expected to influence the economic decisions of users taken on the basis of the financial statements as a whole."

This definition has the advantages of clarifying that omissions are misstatements and that if a misstatement or misstatements are not reasonably expected to influence the economic decisions of users based on the financial statements as a whole, then such a misstatement or misstatements are not material, which sets an appropriate risk threshold

page 8/13 to the comment letter to ESMA dated March 9, 2012

for determining the materiality that applies in a particular instance. The proposed wording would also more closely align the definition with the accompanying guidance, and not combine risk thresholds, which is confusing and may lead to unintended consequences.

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?

Based on our analysis in our response to Q5a, the use of a different threshold would lead to a different assessment of what is material in the circumstances. That is why we suggest an improved definition that leads to a more appropriate risk threshold and leads to greater clarity.

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 that 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. This is because according to the IASB Framework materiality is an entity specific element of relevance that is important to users. Therefore, the overarching objective is to assess materiality in accordance with this definition. However, the IASB should provide more guidance on the meaning of quantitative materiality in the context of the financial statements as a whole and the potential for lower quantitative materialities applying to specific amounts and quantitative disclosures in the financial statements. Such guidance should draw on the requirements and application material in ISA 320. ISA 320 provides useful guidance on how a quantitative materiality level can be determined for the financial statements as a whole using certain bases and percentages. In this context, management should be required to

page 9/13 to the comment letter to ESMA dated March 9, 2012

determine a quantitative materiality level for the financial statements as a whole and, if necessary, lower levels of quantitative materialities for specific amounts and quantitative disclosures in the financial statements. The determination of quantitative materiality (whether for the financial statements as a whole or for lower levels of materiality for specific amounts or qualitative disclosures) would by necessity involve the consideration of qualitative factors.

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.

We note that whether breaches of legal or regulatory requirements are material depends upon the potential financial consequences of the breach. There may be many instances where such breaches have negligible consequences, and are therefore not material. In addition, unusual or non-recurring transactions may also not be material – just because they are unusual or non-recurring does not make them material, unless there are other qualitative considerations involved that imply a greater financial impact. However, we do agree that transactions with related parties, reversals in trends, and key ratios or metrics often require a materiality level that is lower than that for the financial statements as a whole. This is why ISA 320 developed the concept of a quantitative materiality for the financial statements as a whole with the need to consider whether lower levels of materiality apply for certain items. However, determination of both materiality for the financial statements as a whole and the lower levels of materiality for certain other items require the consideration of qualitative factors and therefore the application of judgment.

However, the list of matters requiring a materiality level that is lower than that for the financial statements as a whole is not exhaustive. We doubt it would be actually possible to develop a list covering all likely instances. Further examples are given in ISA 450.A16. While a quantitative analysis may sometimes be practical for a first assessment of materiality, a mere quantitative analysis cannot appropriately be used as a substitute for a full analysis of all relevant qualitative factors.

page 10/13 to the comment letter to ESMA dated March 9, 2012

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 agree that preparers should assess the impact of all misstatements, including omissions, including those from prior periods that are of continued applicability in the current period, when making decisions on the materiality of those misstatements, unless such misstatements are clearly trivial. The fact that the IFRS do not address the issue of misstatements that are clearly trivial when considering the aggregate impact of misstatements suggests that IFRS could be improved by drawing on the requirements and guidance in ISA 450 on this issue.

Consequently, preparers and auditors need to consider uncorrected misstatements from prior and current period for the purposes of financial statement presentation and the auditor's report.

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.

We agree that preparers should assess the impact of all misstatements, including omissions as covered by the paragraphs 24 to 27, unless these are clearly trivial (see the need for IASB consideration of the issue of clearly trivial misstatements in our response to Question 7).

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

The current proposal for a regulation on statutory audits of public interest entities proposes that the auditor's report disclose the materiality level applied. If this proposal becomes EU law, since materiality is a financial reporting issue that is entirely user-driven, audit materiality cannot be different than materiality for financial reporting purposes. Hence, it would be preferable to have preparers make disclosures about the materiality

page 11/13 to the comment letter to ESMA dated March 9, 2012

level applied for the presentation of the financial statements as a whole and of any lower materiality levels applied to other quantitative disclosures, than to have the auditor make such disclosures for audit purposes only. It may be useful to have management disclose the basis for the determination of materiality for the financial statements as a whole and the judgments involved in selecting an appropriate percentage.

Q9b: If so, please provide an outline of the nature of such disclosures.

Preparers should disclose the level of quantitative materiality determined for the financial statements as a whole and any lower levels of materiality for certain other quantitative amounts and disclosures. Furthermore, they should disclose the qualitative factors considered in selecting the base and the percentage chosen for the determination of materiality for the financial statements as a whole.

Q9c: In either case, please explain your rationale in this regard.

Materiality is a financial reporting – not an auditing concept – in the first instance. Therefore, it is important that preparers consider materiality in the first instance. Rather than having only auditors disclose materiality, it would therefore be appropriate that preparers disclose materiality and how it is determined. Auditors would then be required to audit those disclosures, including whether the materiality level or levels and the disclosures about these are appropriate.

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.

Per se, any omission of a note explicitly required by IFRS in relation to a material line item in the financial statements is a misstatement. However, this does NOT imply that such a misstatement is MATERIAL misstatement. Consequently, unless the omitted disclosure is clearly trivial in the circumstances, preparers and auditors need to consider whether such a misstatement is material, either on its own or in conjunction with the other disclosures or other misstatements in the

page 12/13 to the comment letter to ESMA dated March 9, 2012

context of the financial statements as a whole. Once such a consideration has taken place, a decision can be reached on whether the misstatement is material on its own or in conjunction with other misstatements.

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 when considering materiality of any note to the financial statements, emphasis should always be placed on whether its disclosure is relevant to the primary users and would reasonably be expected to impact their economic decisions.

For disclosures that are not directly linked to a line item in the financial statements, determining whether a disclosure is materially misstated depends upon whether the misstatement, whether in itself or in conjunction with other disclosures or misstatements in the context of the financial statements as a whole, would reasonably be expected to change the economic decisions of users. In the case of quantitative note disclosures (whether individually or in aggregate), either the quantitative materiality level for the financial statements as a whole would apply, or a lower level of materiality for certain items, if necessary.

Some qualitative and quantitative disclosures are always material, regardless of their magnitude due to their nature (e.g., disclosure of the interest rates on loans or management remuneration). It would be useful for the IASB to clarify in its requirements for disclosures whether the disclosures required are of this type or whether the materiality considerations mentioned in the first two paragraphs above in the response to this question would be relevant.

page 13/13 to the comment letter to ESMA dated March 9, 2012

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

Pursuant to IAS 34 “Interim Financial Reporting”, the concept of materiality is required to be applied when recognising, measuring, classifying and disclosing any item for the purposes of the interim reporting, just like in case of the annual financial statements. While the standard recognizes that in making a determination of materiality, interim measurements may rely on estimates to a greater extent than measurements of annual financial information, we believe there should not be any difference in the understanding and application of materiality between the interim and annual financial statements. The mere fact that interim figures may rely more on estimates does not and should not change the application of the materiality concept.