



SAP AG
Dietmar-Hopp-Allee 16
69190 Walldorf
Deutschland
T +49 6227 7-47474
F +49 6227 7-57575
www.sap.com

SAP AG, Dietmar-Hopp-Allee 16, 69190 Walldorf

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

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Consultation on Considerations of materiality in financial reporting

Dear Sirs,

We appreciate the opportunity to respond to ESMA's Consultation paper 'Considerations of materiality in financial reporting'. We welcome ESMA's initiative to evaluate the need for further guidance in this area.

We believe that further guidance on the application of the concept of materiality would be helpful to preparers of financial reports. We do, however, not believe that such guidance should be issued by ESMA. As emphasized by the IASB chairman Hans Hoogervorst in the last IFRS Advisory Council the IASB has understood the need for additional guidance in this area. ESMA should therefore support the IASB in preparing such additional guidance rather than add a layer of mandatory accounting guidance to a global set of reporting standards. Such an additional layer would increase the complexity of the regime of accounting guidance and would create the risk of contradictions between the ESMA guidance and similar guidance issued by other regulators or other bodies.

Please find our detailed comments on the Consultation paper in the appendix to this letter. If you would like to discuss any aspect of our comments further, please do not hesitate to contact us.

Best Regards,

Dr. Christoph Hütten
Chief Accounting Officer
T +49 6227 7-63475
F +49 6227 7-830535
E christoph.huetten@sap.com

Sonja Simon
Head of GroupReporting
T +49 6227 7-40553
F +49 6227 7-852468
E sonja.simon@sap.com

SAP AG

Vorstand: Bill McDermott (Co-CEO), Jim Hagemann Snabe (Co-CEO), Werner Brandt, Gerhard Oswald, Vishal Sikka
Vorsitzender des Aufsichtsrats: Hasso Plattner, Registergericht Mannheim HRB 350269
Deutsche Bank AG, Heidelberg (BLZ: 672 700 03) Konto: 0912030, SWIFT-BIC: DEUT DE SM 672, IBAN DE78 6727 0003 0091 2030 00

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?

Generally, we believe that the concept of materiality itself is clearly and consistently understood by preparers, auditors, users and accounting enforcers. However, we also believe that diversity exists in practice in the application of the concept. While one might argue that this diversity in practice indicates that the concept of materiality is not clearly and consistently understood, we believe that the different application of the concepts is due to the management judgment necessarily involved in the evaluation of the question when a misstatement or omission could be material enough to influence the economic decisions of users of financial statements. This management judgment might be influenced by various factors, such as the individual risk appetite of the preparer, auditor or user of the financial statements or the different viewpoints of the preparer, auditor or user of the financial statements. For example, an auditor might generally follow a pre-defined mathematical approach to identify a quantitative threshold to determine materiality (e.g. a certain percentage of profit) but a user of financial statements might follow a different approach entirely.

Therefore we believe that additional guidance in the application of the concept would be helpful.

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

As discussed above, we believe it would be helpful to receive further guidance on the application of the concept of materiality. However, it would be preferable to receive further guidance from the IASB directly as part of an IFRIC to ensure a consistent application of the IFRS standards worldwide. We do not support an approach under which such guidance comes from ESMA because such approach would add a European layer of guidance to IFRS which we believe is not appropriate considering the global approach of IFRS and which results in increased complexity of the regime of mandatory accounting guidance. We fear that Europe could become similar to the U.S. where numerous different sources of mandatory guidance have resulted in a regime of high complexity.

Materiality guidance from a regional body like ESMA also bears the risk that it is not aligned with the respective guidance that other local or regional regulators issue. Companies with public listings in multiple jurisdictions may thus be faced with the challenge to apply different interpretations of materiality to the same set of IFRS financial statements. This could, for example, occur if ESMA provided guidance that is not fully compliant with the materiality guidance issued by the U.S. SEC.

Therefore, we believe that ESMA should work with the IASB to enhance the guidance on materiality within IFRS rather than developing guidance outside IFRS. In the IFRS Council meeting on February 20th and 21st the IASB chairman emphasized the need for additional guidance on materiality.

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 "economic decisions made by users" is not necessarily the same as users making "decisions about providing resources to the entity". One example is an existing or potential investor's decision to buy or sell shares in an entity. The cash flows from such transactions flow from a buyer to a seller and vice versa and do not provide any resources directly to the entity.

We believe that the decisions outlined for the primary user groups in para 9 of the Framework better appropriately explain what the Framework means by "economic decisions" of these users. These include

- for investors the decision "whether they should buy, hold or sell" and the ability "to assess the ability of the entity to pay dividends".
- for lenders the determination "whether their loans, and the interest attaching to them, will be paid when due"

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.

It appears that the primary user groups as defined in paragraph 13 (defined as “existing and potential investors, lenders and other creditors”) includes the users outlined in paragraph 16 as far as these act in their capacity as investors, lenders and other creditors. For example, interests of employees other than whether remuneration and retirement benefits will be paid should not be considered where guidance focuses on the primary user group.

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 the IASB’s use of the word “could” implies a lower materiality threshold than, for example, “would”. We believe that the word “could” indicates that it is not absolutely necessary that a misstatement or error would in fact influence the economic decision of a user. Instead, the word “could” clearly indicates that the possibility of such an influence is in fact enough to be considered material. However, we do not believe that a remote possibility of an influence on the economic decisions is covered by the word ‘could’.

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 do not believe that the inclusion of the expression “reasonably be expected to” could lead to a different assessment of materiality than that used for financial reporting purposes. We believe that the word ‘could’ in the IASB’s wording “could ... influence economic decisions” is to be interpreted as a synonym for “reasonably be expected to”. We have not seen any instance from a different assessment of materiality for auditing purposes resulting from the expression “reasonably be expected to”.

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 the quantitative analysis of the materiality of an item should not be determined solely by a simple quantitative comparison to primary statement totals. However, we believe that it is only appropriate to assess the individual line item in the primary statement to which the item is included if this line item is itself material to the reporting entity. Take for example a reporting entity with immaterial finance cost. A small error in finance cost may thus be quantitatively significant when assessed based on the income statement line item ‘finance cost’. However, this would in our view not result in the conclusion that this error is quantitatively material to the financial statements taken as a whole as the line item ‘finance cost’ and thus the error in this line item will not affect his decision-making.

We therefore believe that a quantitative materiality assessment should start based on the items, subtotals and totals that represent key indicators of the reporting entity’s performance, financial position and cash flows. If an item is quantitatively insignificant based on a quantitative comparison to these key measures this is a strong indicator that the item is not quantitatively material. This indication would, however, be overridden if the line item in the primary statement to which the item is included is material to the financial statements taken as a whole although it is not a key measure (which should occur rarely).

Additionally, we believe that a quantitative analysis should be used as a starting point only and should be supplemented by a qualitative analysis that focuses on whether the users of financial statements might be influenced in their economic decision. Such qualitative assessment may result in both,

- the conclusion that a quantitatively material item is overall not material
- the conclusion that a quantitatively immaterial item is overall material

A number of qualitative factors might influence such an economic decision, for example:

- The primary financial statement in question: amounts that are considered quantitatively material in the income statement might not be considered material in the statement of financial position
- The line item in question: some assets or liabilities are subject to frequent fair value fluctuations such as derivatives, for example. Even if the amounts are not material in one accounting period, such amounts might very well become material in the future. On the other hand, a user of the financial statements may not put a lot of weight on such items due to their high volatility resulting from external factors.
- Continuity within the financial statements: certain assets or liabilities will be expected to develop over time. For example, share-based compensation plans often extend over five years or more. While a liability from such cash-settled share-based compensation plan might not be material in the first accounting period when issued, such a liability could increase significantly in the future. If the amounts are expected to become material in the future, an entity would have to consider this in a quantitative assessment regarding any accounting or disclosure decisions regarding materiality and vice versa.

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 agree that some of the examples provided constitute examples where the materiality threshold may be lower. These examples support our position that a quantitative analysis alone is often not sufficient and should only be used as a starting point.

We do, however, not agree with certain of the items listed in para 22 of the ESMA paper as items “*where materiality judgements are usually particularly sensitive, and thus where the adjudged materiality threshold may be lower*”. Take, for example, the ‘transactions with related parties, including key management personnel’s compensation’ listed in para 22 b) of the ESMA paper. There are numerous reasons why someone may be interested in such information. But not all these reasons should be considered when evaluating the materiality of related party disclosures under IAS 24. The objective of IAS 24 is limited to “*disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties*” (IAS 24.1). The materiality of related party disclosures needs to be evaluated against this objective. Therefore, an omission of management personnel’s compensation would only be a material error in IFRS financial statements if the management personnel’s compensation is material to the financial position and profit or loss of the reporting entity. It cannot be material for other reasons, eg corporate governance issues like a mismatch between compensation and management performance.

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 of financial reports should assess the impact of all misstatements and omissions. In addition, we also agree that misstatements and omissions from prior periods that continue to affect the current period’s financial statements should be considered. From the perspective of a user of financial statements an economic decision is driven by the overall picture presented by the financial statements. Such a completed picture can only be presented if all known misstatements and omissions – including those of a prior period that continue to impact the current period – are considered in the materiality assessment.

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 of financial reports should consider uncorrected immaterial errors, aggregation of individually immaterial misstatements or omissions, netting of misstatements and effects of accumulated misstatements. As discussed above, the users of financial reports will consider the financial statements as a whole in their economic decision. From their perspective, the consideration of aggregation, netting and accumulation by preparers of financial reports is required to achieve a true and fair view of such financial reports. For example, consider two errors in the income statement, one of which results in a positive impact on profit and the other one in a negative impact. As a whole, the income statement would not be materially misstated if those two errors offset each other. However, one if not both of such errors might be material to the respective line item which itself is material to the performance of the reporting entity. In addition, a qualitative analysis of such errors might also be considered material. So even if the income statement would be material correct, there might be other factors to consider.

Applying such approach in practice needs, however, to be operational. It would not be appropriate to require the detailed tracking of all inconsequential misstatements if there is only a remote likelihood that these misstatements, even if taken together with other misstatements could become material.

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

We do not believe that an accounting policy disclosing the materiality judgments exercised should be provided in the financial statements.

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

Not applicable.

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

We believe it is extremely difficult to define an accounting policy which covers all aspects of a materiality evaluation. While it is fairly easy to define a percentage of profit to total assets as a starting point, a qualitative analysis should cover many possible aspects. An effort to describe all of these possible aspects would most likely result in boilerplate language that does not increase the transparency of 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.

We believe that omitting required notes giving additional information about a material line item in the financial statements does not necessarily constitute a material misstatement. We rather believe that two conditions must be met to make the omission of a note disclosure a material misstatement:

- The item that the note disclosure relates to is material
- The information provided by the required note disclosure is material

Take, for example, a reporting entity that has material share based payment expenses. Whether the disclosure required under IFRS 2.47(a)(i) of the option pricing model used could “influence the economic decisions that users make” depends on the individual facts and circumstances and is not by itself given simply because the share based payment expense is material.

We therefore strongly disagree with the notion in para 30 of the ESMA paper that *“the assessment of materiality of such note disclosure is generally determined by the assessment of the materiality of the line item in the financial statements”*.

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 generally speaking, the same considerations should apply. The concept of materiality should be applied consistently in the preparation of the financial statements. Consideration is needed, however, that a quantitative materiality analysis is oftentimes not feasible for qualitative disclosures and thus, management judgment plays an even more important role in materiality assessments of such qualitative disclosures.

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?

Generally, the concept of materiality should be applied consistently in the preparation of the annual as well as interim financial statements. We believe that users of financial statements have an expectation that interim financial statements are based on the same accounting policies, principles and concepts as annual financial statements and it could be misleading to use different materiality concepts for interim versus annual financial statements.

However, as noted in our response to Question 6a, we believe that a materiality assessment should be based on the items, subtotals and totals that represent key indicators of the reporting entity's performance, financial position and cash flows. Users of financial statements may, however, not put the same weight on the quarterly performance of a reporting entity than on the full year performance of the entity. Such difference in importance to the user needs to be considered when performing materiality assessments in interim reports to follow the notion that an item is material if it could influence the economic decisions of users. This does not necessarily result in the notion existing under US GAAP which asks for a materiality assessment of interim reports based on full year numbers. But it may well result in higher materiality thresholds, particularly, where seasonality results in a high quarter-over-quarter volatility of results.

The materiality assessment in interim reports also needs to consider the purpose of interim reports which differs from the objective of annual reports and is limited to “The interim financial report is intended to provide an update on the latest complete set of annual financial statements.”

Particularly, where interim financial statements are viewed as milestones on the way towards a full year performance (eg because management provided guidance for the full year) an error in an interim financial report may not be material if it reverses in one of the following quarters of the year and thus does not impact the assessment of whether the reporting entity achieves its full year targets.