

ESMA
103 rue de Grenelle
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France

Attn.: Frederiek Vermuelen

30 March, 2012

Considerations of materiality in financial reporting

Dear Frederiek,

At the last meeting in the Consultative Working Group of ESMA's Corporate Reporting Standing Committee, we were asked – if possible – to comment on the Consultation Paper concerning Materiality.

Generally, I find that Materiality should be the subject of further study, so that additional guidance can be developed.

Please find my answers to the question below.

Best regards,

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Summary of questions

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?

Yes, I feel that more clarification is needed, but this is based on a feeling and on discussions among professionals. Evidence in this relation is very difficult to obtain. As it is the national accounting enforcers who carry out the inspection of financial statements, the national accounting enforcers are discussing this issue with preparers all over the EU, and they must be the best to know whether or not materiality is clearly and consistently understood. Moreover, I think the concept of materiality is understood, but incentives have an impact on the specific assessments of materiality made, and insufficient guidance will make it difficult for all involved parties to know whether something is material or not.

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

As indicated above, I think that more guidance is needed if we want a more consistent implementation of the materiality concept. As the understanding of materiality is very important when the financial statement is prepared, it would be natural that the IASB prepared a paper on materiality as soon as possible. This solution would imply that the EU would not have to take a unilateral action. If IASB is not going to expand its guidance in this area in near future, it is evident that the enforcers – ESMA – should issue guidance, because this is needed. This does not include that ESMA should become a European standard setter, but only put into practice the IASB rules of materiality, so that the guidance ESMA is issuing is in accordance with IFRS/IAS.

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, this is not the same. Moreover, “decisions about providing resources to the entity” is a subset of the term “Economic decisions made by users”. When an investor makes an economic decision about buying, selling or holding shares in an entity, the investor has to take all alternatives into consideration, including investing in other entities.

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.

One could argue that employees are not part of the user group defined in paragraph 13. When talking about the financial statement, it has to be taken into consideration that the financial statement is not the only source of information to the investors etc. Moreover, the mentioned user groups will have information from press releases etc., and these will normally be more relevant than the financial statement due to the fact that the financial statement will always be late because it has to be audited. Thus, stewardship is also important when the information from the financial statement is assessed.

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. Theoretically, an information source only has content if one or more signals are changing the relevant expected value. This does not necessarily mean that there will be a change of decision. Different individuals can have different utility functions or risk adverse functions, which can induce that the new information will make one individual change his decision and another individual does not change his decision. Using "would" would increase the threshold of materiality, because then all the individuals should change the decision theoretically before the threshold of materiality was met.

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?

No. In my opinion, there are no differences in practice-related matters. Theoretically, there can be a difference, depending on how "reasonably" is defined. If "reasonably" is defined as "the information value must exceed a certain threshold to become "reasonable", then there will be a theoretical difference. This difference can in my opinion not be measured in practice. Thus, there will in practice not be any differences in assessing the materiality using the two different definitions.

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. Moreover, for guidance purposes different kinds of items could be introduced. For reference, see the Danish Securities Council's general considerations and deliberations on the assessment of materiality in relation to its financial reporting of enforcement activities.

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 in-stances which might be cited as examples? Please explain your rationale.

Overall, yes. Development of trends is very important to investors etc. On the other hand, some of the requirements according to national legislation can be immaterial to investors etc. even though these disclosures are required.

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. Misstatements and omissions in prior periods can have an impact on the development of accounting trends, which is very important to the users of the financial statements.

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. For reference, see the Danish Securities Council's general considerations and deliberations on the assessment of materiality in relation to its financial reporting of enforcement activities.

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

No. In my opinion, the Auditor must be the guarantor of the right threshold of materiality being incorporated into the financial statement.

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

N/A

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

N/A

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.

Overall, yes. Moreover, the note can be required even though the information in the note is immaterial. In such cases it is not a misstatement. For example, if an item is fully disclosed in the balance sheet, then further disclosure in the notes is not necessary. On the other hand, if the item in the balance sheet is material and contains different material accounting items, then a missing specification of material items will be a misstatement.

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.

Normally, materiality connected to the P&L and the balance sheet is measured quantitatively. Regarding risk and control (stewardship) notes, the numbers here can be immaterial compared to the threshold used in the balance sheet, but still the information these notes are carrying can be very important to users. Therefore a lower threshold for materiality is needed. In some cases, e.g. related parties, it is not necessarily a question about size, but more about nature. Again, I will refer to the Danish Securities Council's general considerations and deliberations on the assessment of materiality in

relation to its financial reporting enforcement activities, where this problem is looked into.

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?

Interim financial reports are characterized by a greater extent of accounting estimation. Thus, the materiality threshold must be allowed to be relatively higher than it is at the end of the year even though it could be argued that this is not in accordance with IAS 34 para 23-25.