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Dear Mr Maijoor

## **Consultation Paper: Considerations of materiality in financial reporting**

Deloitte Touche Tohmatsu Limited is pleased to respond to the European Securities and Markets Authority's ('ESMA's') Consultation Paper *Considerations of materiality in financial reporting*.

We acknowledge the initiative of ESMA in opening a discussion on this issue. The concept of materiality is critical to both the preparation and auditing of financial statements and as such an understanding of it is necessary for those engaged in either activity. We believe that the majority of preparers and auditors have such an understanding. More significantly, we also believe that existing international accounting and auditing standards provide an appropriate framework for understanding and applying the concept of materiality.

Application of the concept of materiality necessarily involves the application of professional judgement. There are circumstances in which more than one valid conclusion can be reached based on the exercise of such judgement: we do not believe that this necessarily equates to a lack of consistency in the concept's application.

We strongly support the aim of a single set of high-quality financial reporting standards applied without regional variation. For this aim to be achieved, we believe that the fundamental qualitative characteristics underpinning financial reporting, including the concept of materiality, need to be set by the globally-recognised independent standard-setters. For this reason, we believe that any additional elaboration or interpretation of existing international accounting and auditing standards should be provided at a global level by the International Accounting Standards Board and International Auditing and Assurance Standards Board respectively under their established due process (including the consideration of input from securities market regulators and all other constituents). We believe that addressing these issues through accounting and auditing standards applied across many jurisdictions could contribute to global consistency in a way that guidance issued at a national or regional level could not.

Our detailed responses to the Questions for Respondents are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884 or Joel Osness in New York at +1 212 492 3910.

Yours faithfully,



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## Appendix

### Responses to the Questions for Respondents

#### **Question 1: 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?**

We think that the concept of materiality is clearly and consistently understood by auditors, preparers and others trained in accounting and auditing as such training necessarily includes gaining an understanding of the concept of materiality and its application in practice along with the other concepts underpinning financial reporting.

In our view, existing international accounting and auditing standards provide an appropriate framework for understanding and applying the concept of materiality. As discussed further in our response to Question 2, if this consultation provides evidence that additional interpretation of these frameworks is necessary, the IASB and IAASB as the relevant global standard-setters should undertake this exercise in accordance with their established due process.

The question of whether the concept of materiality is consistently applied in practice is more subjective. Application of the concept of materiality is inherently and necessarily a matter of professional judgement, requiring preparers, auditors and securities market regulators to put themselves in the place of a reasonably informed user of financial statements. It may well be the case that more than one conclusion can, quite validly, be reached. We do not believe that honest debate and differing judgements necessarily equate to a lack of consistency.

#### **Question 2: Do you think ESMA should issue guidance in this regard?**

We strongly support the aim of a single set of high-quality financial reporting standards applied without regional variation. For this aim to be achieved, we believe that the fundamental qualitative characteristics applied in financial reporting, including the concept of materiality, must also be applied without regional variation. We believe that addressing these issues through accounting and auditing standards applied across many jurisdictions could contribute to global consistency in a way that guidance issued at a national or regional level could not.

For these reasons, and consistently with our response to Question 1, we believe that any additional interpretation of existing accounting and auditing standards should be provided at a global level by the IASB and IAASB respectively under their established due process (including the consideration of input from securities market regulators and all other constituents).

#### **Question 3: 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 these two phrases in substance convey the same meaning, when considered in the context of the IASB guidance.

In isolation, the two terms may look different. However, considering them in the context of the IASB documents from which they are derived (the IASB’s Conceptual Framework for Financial Reporting (2010) (the *Framework*) and guidance in IAS 1 *Presentation of Financial Statements*

(IAS 1)), we believe that it is clear that the two terms are talking about the same types of decision.

The economic decisions made by the primary users of financial statements (as identified in the *Framework*) in their capacity as existing and potential investors, lenders and other creditors are about resource allocation and as such any distinction between ‘economic decisions’ and ‘decisions about allocating resources’ is likely to be artificial and irrelevant for these users.

These or other users of financial statements also make decisions not concerning resource allocation (*Framework* paragraph BC1.25 identifies this, providing the example of shareholders voting on the reappointment of directors and on management’s remuneration). We agree with the statement made in BC1.26 that, in most cases, information designed for resource allocation purposes would also be useful for assessing management’s performance and their stewardship of the entity’s resources.

**Question 4: 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.**

We agree that the primary users and decisions identified in paragraph 16 (a) and (b) are consistent with the *Framework*’s identification of “existing and potential investors, lenders and other creditors” as the primary users of financial statements. We have the following comments on the examples in paragraph 16 (c)-(e):

- *Framework* paragraph BC1.10 notes that present and potential employees are intended to be encompassed by paragraph OB2. However, a past employee would not typically provide any further resources to the entity and as such would not have decisions to make in that capacity;
- the example in paragraph 16 (d) is, in substance, a repetition of the example in paragraph 16 (b); and
- while certain regulatory requirements may be relevant to decisions made by primary users (for example, compliance with regulatory capital requirements would be relevant to a decision over whether to invest in an entity subject to such a requirement), others would be less relevant to such decisions.

As well as identifying user groups, paragraph 16 also identifies the economic decisions likely to be made by those users. The first two of these are consistent with *Framework* paragraph OB3: we believe that any extension of the examples in OB3 should be provided by the IASB to avoid inconsistencies in the application of this critical principle emerging between jurisdictions. In this respect, we note that the examples in paragraph 16 (c) and 16 (e) are unclear as they identify a qualitative characteristic of the entity but not a decision that a primary user would make based on that quality.

**Question 5a: 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.**

No, we believe that the use of the word ‘could’ provides an operational basis for assessing materiality which is consistent across international accounting and auditing standards whilst an unqualified ‘would’ would not.

Various definitions of materiality are applied in financial reporting and auditing literature, using various formulations to describe the judgement required in determining the likely effect of an item, omission or misstatement on users of financial statements. For example, IAS 1.7 refers to whether an omission or misstatement “could...influence the economic decisions that users make” then expands this by referring to considerations of users’ knowledge, diligence and reasonableness and paragraph 2 of ISA 320 *Materiality in planning and performing an audit* states “... could reasonably be expected to influence...”, whilst FASB’s Statement of Financial Accounting Concepts No. 2 uses the formulation “...it is probable that the judgement of a reasonable person relying on the report would have been changed or influenced...”. Whilst the formulations used by the standard-setters differ, we believe that the underlying concept being expressed is consistent in that all of this literature requires judgement to be applied in assessing the likely effect on a reasonable user.

An unqualified ‘would’, on the other hand, might require identification of a specific user and a specific decision which is affected. This would be inconsistent with the concept of a primary user group and would be impossible to apply. For example, it would be impossible to assess the needs of a potential investor since the detailed circumstances of that investor are generally unknown.

**Question 5b: 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. We believe that the ‘reasonable person’ test is an important element of materiality judgements as judging the materiality of an item, omission or misstatement requires the preparer of financial statements to put themselves in the place of the user of those financial statements. This can only realistically be achieved by assuming that the user would reach reasonable conclusions in assessing the information provided to them. This concept has been upheld in context of US securities law (TSC Industries, Inc vs Northway, Inc 1976).

Further, we do not agree that the concept of reasonableness is absent from the materiality judgements required to be applied under IFRSs. Paragraph 7 of IAS 1 states that “the assessment [of materiality] needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.” We believe that, while the words used by the IASB and IAASB may differ, the concept being expressed is consistent.

**Question 6a: 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. We do not agree that it should be assessed based on the individual line item in the primary statement in which the item is included.

Whilst a materiality figure based on an appropriate benchmark value is an important tool in the performance of an audit and for use as a ‘rule of thumb’ in the preliminary assessment of whether an item, omission or misstatement could reasonably be expected to affect the economic decisions of users of financial statements, we believe it is clear that materiality judgements should be made based on a more comprehensive consideration of the nature of the item, omission or misstatement and any other relevant circumstances.

*Framework* Paragraph QC11 states that “materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report.” We believe that this, along with the statement in IAS 1 and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8) that “materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor” means that a position that materiality can be assessed solely by reference to a single numerical indicator is not tenable. We also note that ISAs 320 and 450 make clear that an auditor must apply a more holistic approach to materiality judgements.

We do not agree that a quantitative analysis of materiality should include an assessment of the individual line item in the primary statement in which the item is included. Whilst we agree that a lower numerical value may be deemed material for particularly sensitive elements of the financial statements (ISA 320.A10 gives the example of disclosure of research and development costs for a pharmaceutical company), this would be a qualitative consideration. Including this assessment in a quantitative analysis would imply a comparison between the numerical value of a misstatement and the numerical value of the line item affected such that a misstatement of a line item with a small numerical value is more likely to be considered material than the same misstatement of a line item with a larger numerical value. We do not believe that this would be an appropriate application of the concept of materiality.

**Question 6b: 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.**

We agree that the examples in paragraph 22 (a)-(e) represent circumstances that would be considered in determining whether an item is material. However, we stress that these should only be seen as indicators that further consideration is required, and do not represent circumstances in which an item should automatically be deemed material. For example, a non-recurring transaction could indicate a decision by management that changes the risks to which the entity is exposed (for example, entering into a derivative contract of a type not normally used by the entity) or a transaction which occurs rarely but is still a normal part of the entity’s business (for example, a small claim on the entity’s normal insurance policies).

We note that ISA 450 *Evaluation of misstatements identified* (ISA 450) includes a similar list of examples. We believe that this is an example of an area in which any interpretation of existing auditing and accounting requirements should be provided by the IAASB and IASB such that consistency at a global level is maintained.

**Question 7: 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, such an assessment would be consistent with the consideration of prior period errors required by IAS 8. In addition, ISA 450 is clear that the auditor shall communicate to those charged with governance all misstatements other than those that are clearly trivial, including misstatements related to prior periods. We are not aware of a body of opinion that those charged with governance can then disregard some of those misstatements on the basis of the period in which they originated or that misstatements identified by a party other than the auditor can be disregarded on such a basis.

**Question 8: 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.**

We agree that the factors identified in paragraphs 24 to 27 are relevant to an assessment of whether the financial statements as a whole are materially misstated as making an assessment at that level requires an assessment of misstatements and omissions in aggregate, with due consideration given to whether ‘offsetting’ misstatements is appropriate and bearing in mind that, per IAS 8.8, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRSs to achieve a particular presentation of financial position, performance or cash flows.

**Question 9a: Do you believe that an accounting policy disclosing the materiality judgements exercised by preparers should be provided in the financial statements?**

**Question 9b: If so, please provide an outline of the nature of such disclosures.**

**Question 9c: In either case, please explain your rationale in this regard.**

No. We do not believe that an accounting policy disclosing the materiality judgements exercised by preparers should be provided in the financial statements. An accounting policy is a principle, rule or convention whereas materiality is a concept. If consideration is being given to disclosure of materiality judgements in the financial statements, we believe that a robust analysis needs to be performed identifying the nature and extent of such disclosures and how they would enhance the decision making capabilities of the users of the financial statements. We would also be concerned about any proposals that a numerical value of materiality should be disclosed. This would be likely to lead to a misconception that materiality is solely a quantitative consideration and that all figures in financial statements are prepared using a level of precision equivalent to that numerical value.

We also doubt whether a requirement for a more discursive disclosure of materiality considerations would meet cost/ benefit or proportionality thresholds. We are concerned that such disclosure would provide only generic, boilerplate information or lead to the disclosure of immaterial information (as disclosing the judgements leading to the conclusion that, for example, a potential legal claim is immaterial would be likely to include details of that immaterial claim). In either case, the increase in the *volume* of information in the financial statements might not result in a proportional increase in the *quality* of the information provided to users.

In addition, we do not believe that IAS 1 paragraph 122 is currently interpreted to require such a disclosure. The interpretation of IAS 1 paragraph 122 presented in paragraph 20 of the Consultation Paper should be assessed by the IFRS Interpretations Committee prior to issuance of any guidance based upon it and that, as stated in our response to Question 2, any resulting guidance should be provided by the IASB.

**Question 10: 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 do not agree that omission of a note giving additional information about a material line item necessarily constitutes a misstatement. IAS 1 paragraph 31 notes that an entity is not required to provide ‘a specific disclosure required by an IFRS if the information is not material.’, the materiality of the line item in the financial statements to which the note relates would be a relevant factor in assessing the materiality of that information and hence whether the disclosure is required, but would not be the only factor considered. We would expect the same holistic approach to be applied to assessing whether the omission of such a note could reasonably be expected to affect the economic decisions of users of financial statements as would be applied in respect of any other omission or misstatement. Please also see the last paragraph in our response to Question 6a.

**Question 11: 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 in general the same considerations apply in determining the materiality applicable to notes which do not relate directly to financial statements items as to those notes which do relate directly to financial statement items, although there are examples of such notes for which qualitative, rather than quantitative, considerations assume particular significance. For example, there may be notes providing significant information, such as a going concern discussion, to which a monetary value cannot be applied and thus a quantitative analysis of materiality would not be relevant. However, as discussed in our response to Question 6, we believe that a quantitative analysis would only ever be one element of a holistic analysis of the materiality or otherwise of an item.

Also, within the population of such notes are items whose nature as well as size may be significant in an assessment of their materiality (for example, transactions with related parties or directors’ remuneration), however this would be due to the specific characteristics of those items rather than any common characteristic of notes which do not relate directly to financial statement items.

We agree that notes providing information concerning the risks to which an entity is exposed are important but would not generally expect the assessment of whether the risk relates directly to a financial statement item to be a consideration in determining the materiality of such a note. For example, we would not consider a liquidity risk analysis of a loan commitment to be more or less

material than one of an interest rate swap on the basis that one relates to an item recognised in the financial statements and one does not.

An IFRS note disclosure requirement, is not, in and of itself, evidence of materiality. As stated in IAS 1.31 and in our response to Question 10, an entity need not provide a specific disclosure required by an IFRS if the information is not material.

**Question 12: 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?**

In principle, we do not believe that the materiality assessment as it applies to interim financial reports prepared in accordance with IAS 34 *Interim Financial Reporting* differs from the materiality assessment as it applies to annual financial reports, the aim still being to assess whether an item, omission or misstatement could reasonably be expected to affect the economic decisions of users of the interim financial report. As stated by IAS 34.23, this assessment would be made in relation to the interim period financial data and would recognise that interim measurements may rely on estimates to a greater extent than measurement of annual financial data.

Interim financial reports prepared under IAS 34 do differ from a complete set of IFRS financial statements in that they are intended to provide an update on the latest complete set of annual financial statements and are produced on the presumption that anyone who reads an entity's interim report will also have access to its most recent annual report (IAS 34.6 and IAS 34.IN6, respectively). For that reason, less information is required to be included in an interim report. We would, however, expect omission of a note required by IAS 34 to be considered using criteria consistent with those required in IAS 34.24-25 with the intent to ensure that an interim financial report includes all information that is relevant to understanding an entity's financial position and performance during the interim period.