Response to ESMA Consultation Paper: Considerations of materiality in financial reporting

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The Institute of Chartered Accountants of Scotland (ICAS) has considered the above consultation paper and I am pleased to forward its comments to ESMA.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

We set out below our general comments on the paper, along with our responses to some of the specific consultation questions.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Technical Policy.

MATERIALITY AND IFRS

Materiality is a key element of financial reporting as it helps determine what information should be included in the financial statements and the level of detail that is required. Materiality contributes towards achieving a 'fair presentation' by ensuring that information provided is relevant, and is at an appropriate level of detail such that the financial statements as a whole are understandable and coherent. The inclusion of items and information that are 'immaterial' would result in an excessive level of detail that obscures the key facts, whilst the exclusion of material items or information would result in an incomplete presentation of an entity's financial performance, position and cash flows.

ICAS has considered the topic of materiality, specifically in relation to financial statement disclosures, in a report published in July 2011 in conjunction with the New Zealand Institute of Chartered Accountants entitled 'Losing the excess baggage'. A copy of the report is available from www.icas.org.uk.

In this report, we note that there is currently a problem in terms of the understanding and application of the concept of materiality in IFRS. We believe that the description of materiality within IFRS is, in the main, appropriate and adequate, but we found that a culture has developed amongst those involved in preparing, auditing and reading financial statements, in which there is a lack of confidence in properly applying the IFRS provisions on materiality. The result of this is, in our view, an excessive level of detail being presented in many sets of financial statements. This has arisen in part because of the increasingly rules-based, prescriptive requirements of financial reporting standards which end up being used as a 'checklist' by preparers, auditors and regulators, and also because of the attitude that it is easier to disclose immaterial items rather than deal with later questions about omitted information from regulators and users.

We propose this problem can be addressed by: amplification and refinement of the description of materiality within IFRS (as we explain below), development of principles-based financial reporting standards that promote the use of judgement in preparing financial statements. This moves away from the 'checklist' mentality, and by increased debate and awareness of the concept of materiality and the role of judgement in financial reporting. In relation to this last point, this consultation paper from ESMA is a useful contribution to the debate; however we strongly believe that any guidance on materiality should be issued by the IASB alone.

As we explain in 'Losing the excess baggage' the IFRS guidance on materiality contains an important distinction between material 'items' and material 'information' which is not currently well-understood. The term 'item' is not specifically defined within IFRS, but is generally used to describe elements that are included within the primary financial statements. 'Information' either relates to items in the primary financial statements, or to other items or circumstances that are not reflected in the main statements, but which are otherwise necessary to give a fair presentation. IFRS separately refers to 'material items' and 'material information' – simply because an item is material, it does not necessarily follow that the information about that item is also material. Each item and piece of information must be separately assessed for materiality. We believe there is currently a tendency to provide all available information related to a material item, regardless of whether that information is itself material. We have proposed to the IASB the following amendment to the IAS 1 description of materiality to clarify this point (underlining shows additional wording proposed by ICAS and NZICA):

An entity need not provide a specific disclosure required by this standard or another IFRS if the <u>item or</u> information is not material. <u>An entity shall therefore determine whether the specific disclosure requirement applies to:</u>

(a) <u>a material item - which is disclosed in the financial statements or notes, in accordance with the requirements in this standard or another IFRS;</u>

(b) <u>material information, including information relating to a material item recognised in the financial statements and other information relevant to the overall view given by the financial statements – which is disclosed only if the information itself is material;</u>

(c) <u>items and information that are not material – which need not be disclosed.</u>

The second key consideration in improving the application of materiality is the role of judgement in financial reporting. Materiality is an entity-specific measure requiring the consideration of quantitative and qualitative factors, dependent on the specific transactions or balances being assessed, as well as on an understanding of who the likely users are. The assessment therefore requires judgement to be exercised by preparers of financial information. Preparers must be able to explain and support their judgements, and to be challenged on them by auditors and others. The latter must also be prepared to accept that judgement is a part of the financial reporting process. ICAS is currently developing a professional judgement framework to assist in applying principles-based financial reporting. We believe this document will be an important contribution to improving the application of materiality as well as to financial reporting more widely. An improved and more consistent understanding of the application of professional judgement will undoubtedly contribute to an improvement in the application of materiality.

Responses to specific questions

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?

Response:
As explained above, we believe that the concept of materiality, while it is well-defined in IFRS literature, is not well-understood, and that action is required by all parties in the financial reporting process to improve this situation.

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

Response:
We strongly believe that ESMA should not issue guidance on the topic of materiality for the following reasons:

- Materiality is an element of the financial reporting framework therefore it should be the IASB's role alone to issue guidance.
- Guidance issued by another body would have an unclear status and would therefore only serve to further confuse the situation.
- IFRSs apply internationally; therefore any guidance issued by ESMA for the European markets could result in a different interpretation of materiality applying in Europe compared to the rest of the world.

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.

Response:
No, we disagree that the IASB's use of the word 'could' as opposed to, for example, 'would' implies a lower materiality threshold. The word 'could' simply reflects the element of uncertainty inherent in the process of assessing materiality. A preparer of financial statements cannot predict with certainty what decisions users may take based on the information they have prepared – 'could' is less definitive than 'would' and is therefore the most apposite word to use. It would be preferable for the IAASB wording on materiality to be aligned with that of the IASB.

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.

Response:
We strongly disagree with this statement. As we have explained above, IFRS draws a distinction between material 'items' and material 'information'. Information is not required to be disclosed if that information is not material. Thus in relation to each material item, preparers must consider if each piece of information about that item is in itself material. We believe this assessment is essential to ensuring that disclosures are focussed on the key items and key information, and are not obscured by reams of immaterial detail.