

Submitted by email

European Securities and Markets Authority  
103 Rue de Grenelle  
75007 PARIS  
FRANCE

Amsterdam, 21 February 2012

Ref: B2012.14

Subject: Eumedion's response to ESMA's consultation paper 'Considerations of materiality in financial reporting'

Dear Sirs, dear Madams,

Eumedion welcomes the opportunity to submit comments on ESMA's consultation paper 'Considerations of materiality in financial reporting' (document nr. ESMA/2011/373). By way of background, Eumedion is the Dutch based corporate governance forum for institutional investors. Our 68 Dutch and non-Dutch participants together have more than EUR 1 trillion assets under management. They invest for their clients and their beneficiaries in listed companies worldwide. Our views therefore represent a perspective of users of financial statements.

Before answering the questions in the consultation document, we would like to share our key thoughts on the subject.

1. Discussions on materiality between the external auditor and the reporting company rarely surface to a level visible to investors. Therefore, we have little to no evidence whether that is because there are no such problems, or whether there are problems, but external auditors and reporting entities tend not to disclose any difficulties encountered.
2. We strongly support the European Commission's proposal to improve disclosure on materiality<sup>1</sup>, as we expect it to help raise investor awareness.

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<sup>1</sup> Article 22.2.j of the proposal for a regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities: 'lay out the details of the level of materiality applied to perform the statutory audit'.

3. We highly appreciate ESMA for publicly raising its concerns on the lack of a consistent view on materiality by preparers, auditors, users and in some cases accounting enforcers, as we wonder which body would have otherwise raised these concerns. We see the inconsistent views as a potential threat to the quality of the financial statements of listed companies and harmful for investor interests and confidence.
  
4. The consultation document could have provided a more detailed description of the problems, and what role ESMA sees for itself in getting towards a solution. We question whether a securities regulator should provide more guidance. We see the International Auditing and Assurance Standards Board as 'first in line' to provide additional guidance globally. We expect such guidance to be most effective if it were principle based.

Additionally, we would like to share an observation with ESMA: we sometimes see companies forego on disclosing material information, not by disputing materiality, but by using the following arguments:

- 'There is no specific IFRS for reporting such information';
- 'We do not want to be the first company (or country) to provide such information to investors'.

In fact, none of the 75 largest Dutch listed companies fulfilled our written request to disclose in the 2010 annual report or statements how much of the reported fully consolidated cash balance is owned on a proportionate basis; i.e. the cash balance excluding the amount that would flow to external shareholders if it were upstreamed to the parent. We regard this information as key for assessing liquidity, risk and value of any company that consolidates a subsidiary that is not fully owned. Please note that approximately 90% of the 500 largest companies in Europe fully consolidate partly owned subsidiaries.

#### **Answers to the questions 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?*

In practice the concept of materiality is not always clearly and consistently understood and applied. Users and preparers of financial statements sometimes use another concept of materiality than auditors. Auditors also refer to materiality as described in auditing standards, including quantitative and qualitative factors. The definition of materiality as described in note 9 is a clear definition, and well useable in practice. Furthermore we note that materiality is described in several International Financial Reporting Standards (IFRS), but we believe users would benefit if the International Accounting Standards Board (IASB) were to centralize these in one IFRS.



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

We agree that more guidance is required. Because ESMA is an organisation of oversight bodies, it is not the most obvious party to issue guidance. It is preferable that because the IFRS are international standards, an international organisation like the International Federation of Accountants (IFAC) issues such guidance. If guidance were given, principle-based instead of rule-based guidance is needed to make it possible to take into account entity-specific circumstances. This requires professional judgment on the basis of principle-based guidance.

*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.*

In our opinion the distinction between the two is not relevant, since the standards are focusing on the primary users of the financial statements, including existing and potential users. We agree with the IASB that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful for the primary users.

*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.*

Paragraph 13 gives a clear description of the type of users, and which users are the primary users. Paragraph 16 describes which type of decisions primary users make and the kind of information they need. We agree with the type of decisions as mentioned under 16 a – d. Paragraph 16e “the entity’s compliance with certain regulatory requirements” is in our opinion too widely defined, for example if users want to know whether the company complies with environmental legislation, users could get information in this regard by using other information/reports than financial statements.

*Q5 A): 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 word “could” is broader and more conservative than the word “would”; therefore we are in favor of using the word “could”. However using another word does not impact the assessment regarding materiality, in other words using another word does not reduce the threshold regarding materiality.

*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 for financial reporting purposes. Have you seen any instances of this in practice?*

No. In our opinion “reasonably be expected to” is already included in the word “could”; therefore it does not impact the assessment regarding materiality for auditing purposes and for financial reporting purposes. However from a semantic point of view we prefer including the expression “reasonably be expected to” as per the Auditing Standards.

*Q6 A): 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, we agree. As mentioned under Q1, both quantitative and qualitative factors are relevant in assessing materiality; it is not just a mathematical exercise. Because of that we suggest to encourage including more information in the financial statements about the materiality and thresholds used for preparation of the financial statements.

*Q6 B): 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.*

Yes, we agree. There could be other instances which might be cited; however this depends on the particular circumstances and the specific financial statements.

*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, we agree. We regard this as obvious in the situation that a misstatement has influence on the current year's result.

*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, we agree, preparers of financial reports should assess the impact of all misstatements and omissions as referred to in paragraph 23 to 26 above in determining materiality decisions.

*Q9 A): Do you believe that an accounting policy disclosing the materiality judgments exercised by preparers should be provided in the financial statements?*

Yes, we think that this is very relevant information for the users of financial statements. However not all individual policy management judgments need to be disclosed, only the significant ones. Only material information should be included in the financial statements. Furthermore disclosures should be limited to material items and the tendency to just add more information instead of choosing which information is useful and which information can be left out, should be resisted. In other words all clutter needs to be removed and boiler plate language in this respect has to be avoided.



Q9 B): *If so, please provide an outline of the nature of such disclosures.*

We refer to our answer to Q9A.

Q9 C): *In either case, please explain your rationale in this regard.*

We refer to our answer to Q9A.

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.*

No, we do not agree. Not for all line items in the balance sheet above materiality disclosure is required. Professional judgment is required to determine if it constitutes a misstatement when required notes giving additional information about a material line item are omitted 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.*

Option a.

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?*

The same assessment principles regarding materiality are used for interim financial statements, as for year end financial statements.

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Martijn Bos ([martijn.bos@eumedion.nl](mailto:martijn.bos@eumedion.nl), +31 20 708 5885).

Yours sincerely,



Rients Abma  
Executive Director