

21 February 2012

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

Submitted via the consultations page at www.esma.europa.eu

Dear Sirs

Consultation Paper - Considerations of materiality in financial reporting

I am writing on behalf of AFME (the Association for Financial Markets in Europe) to respond to the ESMA Consultation Paper - Considerations of materiality in financial reporting (“the CP”), which was published on 10 November last year. AFME is, as you probably know, the principal European trade association for firms active in investment banking and securities trading; it was established in November 2009 as a result of the merger of LIBA (the London Investment Banking Association) and the European Branch of SIFMA (the US-based Securities Industry and Financial Markets Association), and thus represents the shared interests of a broad range of participants in the wholesale financial markets.

General Comments

We agree it is important that those involved with the preparation and/or use of financial statements share a common understanding of the concept of materiality and of its practical application in financial reporting, and we therefore welcome the opportunity to comment on this CP. Before turning to the CP’s specific questions, we have a number of high level comments on the key issues:

- We note that the CP reports “apparent differing views regarding the practical application of the concept of materiality” arising at meetings of European and National Enforcers. This is not the experience of our members, who report that the concept of materiality, and its practical application in financial reporting, are well understood by preparers and users within the principal EU financial markets. Accordingly, in the absence of more specific information on the issues reported in the CP, we do not believe there is a need for further clarification on these matters.

Association for Financial Markets in Europe

- Notwithstanding the above, should ESMA conclude in its forthcoming report that there is a need for greater clarity around the concept of materiality and its practical application, we believe this should be referred to the IASB with a request to make appropriate amendments to, and/or to issue supplementary guidance for, relevant IFRS and/or the Conceptual Framework.
- It follows, we believe, that the role of ESMA in this area should be confined to identifying concerns regarding consistency of understanding and application of the concept of materiality, to raising such concerns with the IASB, and to ensuring that National Enforcers are applying the relevant parts of IFRS and/or the Conceptual Framework in a broadly consistent manner, both within their own jurisdictions and across the EU.
- We would particularly caution against ESMA itself seeking to issue any guidance on the concept of materiality: we believe this could lead to an “EU GAAP” approach to its application which might differ from its interpretation and application in other key financial markets, and could thus inhibit progress towards a single set of global accounting standards.

Our responses to the questions set out in the CP (and summarised in Annex 1) are set out below.

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?

As indicated in our general comments above, we believe the concept of materiality is clearly and consistently understood - at least in the larger financial markets in which our members have their principal EU operations. Materiality has for many years been a core principle embodied in all major accounting frameworks (including IFRS), and there is therefore significant experience amongst preparers, auditors and users as to how the concept should be interpreted and applied.

While our initial opinion is therefore that further clarification of the concept of materiality is not required, we recognise that discussion at ESMA-hosted fora will involve representatives of other constituencies whose experience may have generated different views; we believe it would be helpful to those responding to the CP, and to any wider discussion on this topic, if any such views could be made public.

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

If ESMA were to conclude as a result of this consultation that further clarification is required, we strongly recommend, as indicated above, that such clarification should be provided by the IASB, and not by ESMA itself: it is, we believe, for the IASB rather than ESMA to issue any required guidance to preparers on how to apply the concept of materiality. ESMA does however have a role in ensuring that different National Enforcers approach the enforcement of IFRS (including the application of materiality) in a broadly consistent manner, and there may therefore be scope for ESMA to issue guidance to enforcers on how this aspect of their role should be undertaken.

We also recommend caution in respect of any clarification that might be issued: the application of the concept of materiality is ultimately a matter of judgment, and different entities will not always apply it in exactly the same way. As with other judgmental areas, there will often be different, and equally valid, ways of applying the same concept to the same fact pattern; we therefore believe it is important to allow preparers a degree of flexibility in this regard, not least so that they can reflect the particular circumstances that affect a specific reporting entity and/or the markets in which it operates. While setting bright lines to define materiality thresholds might ostensibly reduce inconsistent application, it would not, in our view, improve the quality of financial reporting. There is, moreover, a risk that any such guidance could be seen to reduce, or even to remove, the need for preparers to use judgment in determining what they see as material: we would see such a change as potentially detrimental to the quality of financial reporting.

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 “users”, in the context of the definition of “material” quoted in paragraph 9a of the CP, should be understood to mean the different user categories set out in paragraph OB2 of the Conceptual Framework: i.e. “existing and potential investors, lenders and other creditors”. While we think this should lead to “economic decisions made by users” being the same as users making “decisions about providing resources to the entity”, we believe there could be an ambiguity about whether an actual or potential buyer or seller of shares in the secondary market is making a decision “about providing resources to the entity”. For the avoidance of doubt, we therefore prefer the phrase “economic decisions made by users”. Here again, we believe any possible ambiguity and/or inconsistency should be for the IASB to resolve rather than ESMA.

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.

We agree that the primary user constituency of general purpose financial statements as defined by the IASB and quoted in paragraph 13 of the CP, includes those users as outlined in paragraph 16. In particular, although there is no specific reference to “present and past employees” in the IASB’s definition of “primary users”, we agree with ESMA’s implied view that these should be considered as “other creditors”, since they provide services to an entity in return for financial and non financial benefits (i.e. current and post employment remuneration, benefits in kind, job security, etc).

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 “could” implies a lower materiality threshold than “would”, and we also believe that this is appropriate. Users’ decisions are typically not made in a purely mechanistic way (and indeed may not always appear 100% rational to third party observers); it follows that there is a range between items that may be relevant to (“could influence”) their decision making, but which they ultimately choose to disregard, and items that certainly would affect (“would influence”) their decisions.

Notwithstanding the above, we believe that “could influence” should be taken to mean “could reasonably influence”, rather than “there is a theoretical possibility that it could influence”: here again judgment must ultimately be the test of whether “could influence” is being applied in a sensible manner.

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?

As indicated in our response to the previous question, we believe that “could influence” should be understood to mean “could reasonably influence”, and it therefore follows that the Auditing Standards use of the expression “reasonably be expected to” should not lead to a different assessment of materiality for auditing purposes to that used for financial reporting purposes; we are, moreover, not aware of any instances of such differences arising in practice. If, however, ESMA has evidence that this difference in wording is causing, or potentially might cause, a problem, they should refer this issue to the IASB and IAASB with a request for those bodies to harmonise their wording and/or to issue mutually agreed guidance to ensure that unintended differences of application do not arise.

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. Any assessment of whether a specific item is material should, we believe, also take into account qualitative factors and the context of the item concerned, including particularly the line item in which it is included.

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 the examples provided in paragraph 22 a-e (not paragraph 21, as stated in the Question) constitute instances where the quantitative materiality threshold may be lower. Since other such examples may well exist, we think it important that, if such a list is to be included in the ESMA report or in any prospective guidance, it is clear that the list is not exhaustive. In this context we note that the FASB Accounting Standards Codification (ASC 250-10-S99) contains a very similar list; we suggest ESMA should consider including a cross-reference to the FASB list in their final report.

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 find the wording of this question to be somewhat unclear, but we agree that it is appropriate, in assessing the impact of misstatements and omissions, to consider corresponding misstatements and omissions that arose in earlier periods and are of continued applicability in the current period.

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 assess the impact of all misstatements and omissions as referred to in paragraphs 24 to 27 (not 23 to 26, as stated in the Question) in determining materiality.

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

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

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

We believe the existing requirements to disclose material assumptions made in preparing the accounts are sufficient to cover the application of materiality judgments. We would therefore be against any extension of these requirements, which we believe would be likely to result in “boilerplate” wording that would be of no additional benefit to users, and could indeed detract from the overriding requirement for preparers to exercise judgment in determining what information is most useful to be disclosed.

More specifically, if a preparer has determined that a specific item is not material, then by definition it is not required to be disclosed; conversely, if an item is determined to be material, then it will be disclosed. Having a separate disclosure as to whether or not a materiality judgement has been made would in itself be contrary to the basic concept of materiality.

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 agree that omission of a disclosure that is required by IFRS about a material line item would constitute a misstatement. We note, however, that whether the omission of a disclosure would itself be material would be dependent on a separate analysis.

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

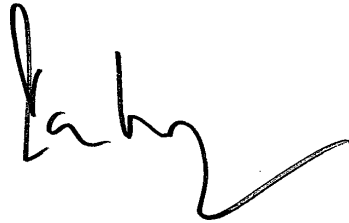
We believe the same considerations are relevant in determining the materiality applicable to notes, whether or not they relate directly to financial statement items: the key materiality test is, as before, whether the information could influence users’ decision making.

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?

Applying the materiality assessment to interim reports is, we believe, in principle exactly the same as applying the assessment to annual financial reports. Determining whether a misstatement could influence a user's decision-making, however, requires looking at the context in which the information is provided, and it is possible that there may be cases where the context of an interim financial report is sufficiently different from that of an annual financial report that there could be a different assessment of the materiality of a specific item. In most cases we believe this will not occur.

I hope the above comments are helpful. We would of course be pleased to discuss any points which you may find unclear, or where you believe AFME members might be able to assist in other ways.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ian Harrison', with a long, sweeping underline.

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