

THE DANISH SECURITIES COUNCIL (FONDSRÅDET)

The Danish Securities Council's general considerations and deliberations on the assessment of materiality in relation to its financial reporting enforcement activities

1. Introduction

In connection with the Danish Securities Council's enforcement activities regarding financial information in the annual and interim reports of listed undertakings, inquiries have been made as to the Council's assessment of materiality. The reason for the inquiries is that the assessment of materiality is based on individual judgement and that different persons may have different views on what is considered material. Guidelines are therefore needed to ensure a more uniform assessment of materiality. In response to this, the Danish Securities Council has prepared a memorandum setting out the Council's considerations and deliberations in assessing accounting materiality in annual and interim reports on a general level.

These considerations and deliberations, principally prepared for the purpose of the Danish Securities Council's secretariats in their enforcement activities, should be seen as a supplement to the Council's existing practice concerning the materiality level of misstatements in annual and interim reports. Until now, the Council's enforcement decisions have largely related to misstatements in terms of recognition and measurement. The purpose of publishing this memorandum is to give reporting undertakings as well as users of financial statements an insight into the Council's general considerations regarding the assessment of materiality. The Danish Securities Council's enforcement decisions, which are always based on an individual assessment and therefore solely reflect practice in this area, are available at the Council's website (www.fondsraadet.dk), which is regularly updated.

The mentioned considerations and deliberations, which are naturally not exhaustive, deal with materiality in connection with financial reporting and related enforcement activities in various contexts and "dimensions", including:

- financial reporting regulations (Danish GAAP and IFRS) applied;
- financial statement components;
- recognition, measurement and classification; and
- disclosures.

2. About materiality in general

The IFRS's define materiality in the following way: (Framework (30)):

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

Information in the financial statements is thus material according to the IFRS Framework if its omission or misstatement could affect the economic decisions of users. The phrase “materiality depends on the size of the item or error judged in the particular circumstances ...” means that materiality should always ultimately be assessed on an individual basis according to an assessment of the specifics of each case.

Also, the IFRS Framework classes materiality as a sub-point under the qualitative characteristic of “relevance” rather than as an independent qualitative characteristic. Consequently, reporting undertakings are not required to assess whether a matter is material in order to include it, but are allowed to exclude it only if it is immaterial. Finally, it is stated that the particular circumstances of the misstatement or omission are central to the assessment of its materiality.

IAS 1.7¹ states that:

“Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. 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.”

Accordingly, based on the above it can be concluded that at least three important factors should be considered in determining materiality:

- the size of the item/disclosure;
- the type/nature of the item/disclosure and
- the particular circumstances of misstatement or omission.

These factors each influence the assessment of whether or not it is a case of misstatement, but the weighting of each individual factor in the assessment will depend on the type/category of information which is to be assessed.²

IAS 8 (8) states as follows on materiality in relation to recognition and measurement:

“IFRS’s set out accounting policies that the IASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRS’s to achieve a particular presentation of an entity’s financial position, financial performance or cash flows.”

Similarly, IAS 1 (31) states as follows on disclosure requirements:

¹ In the amendment to IAS 1 which is effective for financial years beginning on or after 1 January 2009. Earlier application is permitted, however. The definition corresponds to the definition in the previous IAS 1.11, except that in that standard the first sentence read: “... decisions of users taken on the basis ...” rather than “... decisions that users make on the basis ...”.

² See for example ICAEW, The Institute of Chartered Accountants in England and Wales, *Guidance on Materiality in Financial Reporting by UK Entities, June 2008*.

“Applying the concept of materiality means that a specific disclosure requirement in a Standard or an Interpretation need not be satisfied if the information is not material”.

Generally, the requirements set out in legislation and financial reporting standards are an indication that the regulators and the standard-setting body consider compliance with the stated recognition and measurement requirements and disclosure requirements to be relevant for the users of financial statements, unless they concern matters irrelevant or immaterial to a specific entity’s annual report. A note or presentation requirement should therefore be met, unless non-disclosure would be immaterial. If compliance with the requirement is immaterial to the economic decisions of users, non-compliance with the requirement would be a permissible departure from the financial reporting rules under IFRS or, in other words, would not constitute a “misstatement”. Conversely, if a requirement which is considered material in accordance with the Framework’s definition of materiality is not met, this would constitute a misstatement because it could affect the economic decisions of users.

Although materiality is not defined explicitly in the Danish Financial Statements Act or the Danish Financial Business Act, the concept of materiality in the two acts is in practice assumed to be consistent with that of IFRS. Section 13(1)(iii) of the Danish Financial Statements Act and section 188 (1)(iii) of the Danish Financial Business Act state that:

“All relevant matters must be included in the annual report unless they are insignificant (materiality). But where several insignificant matters are deemed to be significant when combined, they must be included.”

In an annual or interim report prepared according to IFRS, it is similarly assumed that matters considered individually immaterial may in aggregate be considered material and thus constitute a misstatement.

Accordingly, financial statements may not generally comprise misstatements or omissions, but if an undertaking is able to justify that the departure is immaterial and is able to document such justification,³ the undertaking may refrain from correcting the departure or from including the omitted information in the financial statements. In other words, it is not sufficient to assume that a matter is immaterial. The undertaking should also be able to argue that this is the case. However, IAS 8(8) also states that it is inappropriate to leave uncorrected (individually immaterial) departures in order to achieve a particular presentation of the undertaking’s financial position, financial performance or cash flows (intentional misstatement). This is discussed further in section 3.3 below.

It should be noted that the Danish Securities Council has decided to change its terminology, so that what was previously termed “material misstatements” will in this memo and in future be termed “misstatements” and “immaterial misstatements” will be termed “permissible departures”.

Whether a misstatement exist will, as mentioned initially, always be subject to an individual assessment.

In case of possible individual misstatements, the individual assessment is generally based on the

³ For example, it will be easier for an undertaking to justify that a departure in the form of omission to recognize minor acquisitions in the balance sheet is permissible if it is able to demonstrate that assets such as computers are replaced on an ongoing basis, rather than if they are replaced in “lumps”.

size, type/nature and particular circumstances of the item/disclosure, weighted according to the size of the item or the purpose of the disclosure under the chosen framework. In determining whether several permissible departures in aggregate constitute a misstatement, it is generally assessed whether the overall effect of the departures, including their effect on for example the direction and strength of development, could affect the economic decisions of users, made on the basis of the annual or interim report.

Based on the above, the Danish Securities Council in this memorandum sets out some overall considerations and deliberations, which will form the basis for the determination of misstatement or permissible departure in future enforcement decisions, whether made by the Council itself or by the Danish Financial Supervisory Authority or the Danish Commerce and Companies Agency on behalf of the Council.

3. Types of misstatement

In the following, the different types of misstatement are discussed as well as the factors deciding whether it is a case of permissible departure or misstatement. The following types of misstatement will be discussed:

- application of incorrect financial reporting regulations (section 3.1);
- missing components of the annual report (section 3.2);
- recognition, measurement and classification misstatements (section 3.3);
- aggregation of permissible departures (section 3.4);
- misstatements and omissions regarding disclosure requirements (sections 3.5-3.8).

3.1 Application of incorrect financial reporting regulations

Listed undertakings are required to present their financial statements in accordance with either IFRS or Danish financial reporting regulations, the Danish Financial Statements Act or the Danish Financial Business Act – depending on the type of financial statements and the type of undertaking – in combination with statutory orders on financial reporting. Moreover, undertakings reporting under IFRS must comply with a number of additional Danish disclosure requirements set out in the so-called statutory orders on adoption of IFRS.

If a company has prepared its financial statements according to a different set of financial reporting regulations than required, for example according to the Danish Financial Statements Act instead of IFRS, this is considered a misstatement.

The reason for this is that the financial reporting regulations in themselves constitute a "code" indicating to users what they are dealing with (a certain type of recognition and measurement rules that for instance entail a specific method of measurement and access to certain minimum disclosures). If the financial reporting regulations applied are not the ones required, users will find it difficult to compare with other undertakings as the decoding of their financial statements is different. For example, applying a Danish set of financial reporting regulations rather than IFRS will normally entail that significantly less information is disclosed to users or that the measurement of assets and liabilities is made on a different basis. Also, it will not be possible - or will require considerable effort - to determine whether all relevant information has been disclosed or may be found in other parts of the annual report than that required under the required financial reporting regulations. Consequently, users will lack assurance that all required information is disclosed.

Even if the application of alternative financial reporting regulations is disclosed in the accounting policies, such application of incorrect financial reporting regulations will still constitute a misstatement.

In other words, in order to be a misstatement, it is not decisive whether the application of incorrect financial reporting regulations results in the recognition or measurement of materially different amounts in the income statement or balance sheet, nor is it generally decisive whether the required disclosures are included elsewhere in the annual report. For example, material information to be disclosed in the financial statements cannot be moved to the management's report. This is enhanced by the fact that management's reviews will no longer be audited as from the 2009 financial year.

3.2. Components of the annual report

Annual reports should comprise a number of components, normally including: management's report; balance sheet; income statement; statement of changes in equity; cash flow statement; notes and management's statement and auditors' report. A cash flow statement is not required for financial undertakings reporting under the Danish financial reporting regulations, however.

If one of these components is missing, it will mean that material information – see section 2 – will not be available to users, and such omission will therefore be considered a misstatement.

3.3. Recognition, measurement and classification

In relation to recognition and measurement misstatements, it is normally irrelevant whether the misstatement results in an increase or a reduction of the undertaking's financial results and equity. This is based on the principle of neutrality in IFRS as well as the Danish financial reporting regulations. A neutral best estimate should always be made, rather than a conservative estimate.

In this respect, it is also of significance whether the actual trend in for example performance is changed. If the perception of the direction and strength of a company's performance is changed, for instance because a profit is erroneously presented as a loss, or the reverse or if the reversal of a previous trend is not reflected, even minor misstatements may be material. This is described in IAS 8 (8), last item, mentioned in the introduction above, which states: "However, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRS's to achieve a particular presentation of an entity's financial position, financial performance or cash flows."

In previous financial reporting regulations, which favoured a consideration for creditors rather than for investors, there was a tendency for misstatements reducing financial results and equity to be more acceptable than misstatements increasing them. Incentives still exist, for example in the law of tort, to favour a consideration for creditors. Such consideration would be contrary to the neutral best estimate requirement, however.

An incorrect classification of a material asset or liability in the balance sheet is also considered a misstatement. Incorrect presentation, for example where a material item is moved down in the income statement so as not to be included in sub-totals further up in the statement, is also considered a misstatement. This might, for example, be the case where the equity method is used to value associated undertakings and the result of investments in associated undertakings solely

comprises the proportionate share of the profit before tax, and the tax charge in that respect is included in the tax charge for the year.

If an incorrect term is used for a material income statement item, for example using the term extraordinary expenses or extraordinary income in financial statements prepared in accordance with IFRS, this is also considered a misstatement. If, for example, an agency recognises gross revenue rather than agent commissions in the income statement item "Revenue", this is considered a misstatement as well if these differ materially in amount.

The practice in terms of what is considered misstatements in relation to recognition and measurement has been established through a number of specific decisions made by the Danish Securities Council. In this connection, it should be stressed that the Danish Securities Council in some of its enforcement decisions has questioned estimates made by an undertaking's management, as this is a natural part of the enforcement activities regarding financial reporting, cf. the legislative history.

The practice established through the enforcement decisions made was inspired, among other things, by the memorandum on materiality issued by the Danish Institute of State Authorised Public Accountants in August 1996.

The Institute of State Authorised Public Accountants considers this memorandum to be outdated and has issued a new auditing standard: RS 320 "Væsentlighed ved revision" (Audit Materiality).

As mentioned, the Danish Securities Council's practice in terms of which items materiality should be measured against and which relative sizes of misstatements should be considered material, was inspired by the previously issued memorandum. The practice was not established by weighting concrete percentages, indicated in the mentioned memorandum as guiding for the determination of the materiality level in the financial statements, but rather solely on the basis of specific decisions, each made after deliberation and assessment in each case taking into account various factors, including the above-mentioned trend. Against this background, the Danish Securities Council considers that the adoption of the new auditing standard, RS 320 "Væsentlighed ved revision" does not call for a change of the Council's existing practice.

3.4. Aggregation of permissible departures

In the assessment of whether the financial statements are misstated, consideration should be given not only to individual departures but also to the aggregate of departures. A number of departures which individually are considered immaterial, and as such may be considered permissible departures, when aggregated may mean that the financial statements are misstated according to an overall materiality assessment. This is also pointed out in RS 320(12).

Moreover, one misstatement may not be set off against another, even if one is positive and the other negative. It is the Danish Securities Council's practice that set-off of two opposing recognition or measurement departures regarding the same item is not assessed to affect the information derived from the item in question, and this is therefore not considered a misstatement. It should be noted, however, that such departures may result in misstatement of the notes to the financial statements. See section 3.7.1.

3.5. Disclosure requirements

The inclusion of a disclosure requirement in financial reporting standards or legislation is an indication that the standard-setting body generally considers the stated disclosure to be relevant for the users of financial statements, unless it concerns matters irrelevant or immaterial to a specific entity's annual report, as stated in section 2.

When determining a materiality level for disclosures, it is therefore necessary to set out guiding principles as to which disclosures in a given annual or interim report are to be considered material or immaterial. Generally, as described in section 2, these principles are based on a weighted combination of: The size of the amount, the type or nature of the disclosure and the particular circumstances. The qualitative size of an item will naturally be deemed the most important in an assessment of recognition and measurement misstatements, but this may not necessarily be the case in the assessment of more qualitative disclosure misstatements, as these do not directly affect either financial results or equity but may, nonetheless, be essential to the assessment of the financial position or other circumstances concerning the reporting undertaking.

To operationalise the assessment of materiality in relation to note disclosures, the Danish Securities Council has chosen to divide the notes into the following categories:

- accounting policies;
- explanatory notes relating to financial statement items;
- explanatory notes providing an alternative measurement option;
- risk notes;
- control notes.

Each category is examined separately below.

3.6. Accounting policies

The requirement for a description of accounting policies should be seen in light of the requirement that a particular set of financial reporting regulations or particular financial reporting standards be applied. Users need to know which code/which choices have been applied in preparing the financial statements in order to be able to decode the information contained therein. It is therefore not sufficient to state which regulations have been applied or to reproduce these. Users of the financial statements have to know which specific measurement alternatives the reporting undertaking has chosen, which significant assumptions it has made in relation to specific measurements and what particular uncertainties apply to the recognition and measurement of material items.

For example, if an applied model is inaccurately described and the result arrived at using the described method differs materially from the recognised amount, this is considered a misstatement.

Omission of significant parts or all of this note or a materially misstated note content is therefore considered a misstatement in line with the application of incorrect financial reporting regulations.

3.7. Explanatory notes

3.7.1. Notes relating to financial statement items

A sub-category of the notes to the financial statement are notes relating to specific financial statement items, and can thus be termed explanatory notes⁴. The assessment of the materiality of this type of note is generally connected to the assessment of the materiality of the item. Accordingly, omitting required notes giving material additional information about a material financial statement item is considered a misstatement. This applies regardless of whether the note is one that distributes an amount on a number of sub-items or one that quantitatively and/or qualitatively explains how the item is measured. Similarly, misstatements that result in a misleading impression of the underlying composition of a material item are considered material. Examples of this are impairment losses on loans resulting from individual and collective impairment losses, respectively. This also applies in case of notes containing material sensitivity information.

Conversely, the omission of a note relating to an immaterial financial statement item is considered immaterial in so far as it is solely a specifying note. This might, for example, apply to the specification requirements in relation to a pension obligation recognised in the balance sheet which in itself, gross as well as adjusted for any related pension assets, represents an immaterial financial statement item.

The assessment of whether a note, the omission of which is considered a misstatement, contains misstated information will be based on the same materiality level as that used for recognition and measurement.

3.7.2. Notes providing supplementary measurement information

The omission of required notes providing users with material supplementary measurement information is considered a misstatement, unless the recognised amount as well as the amount disclosed in the note is immaterial.

For example, the omission of a note disclosing the fair value of material financial instruments recognised at amortised cost is considered a misstatement, as this deprives users of the supplementary measurement information reflected by the requirement.

Whether, for example, a bank's note disclosure of the fair value of a loan portfolio recognised at amortised cost is misstated must consequently be assessed in the same way as recognition and measurement misstatements.

3.7.3. Risk notes

A number of notes do not relate directly to financial statement items but are nonetheless of significant importance for the overall assessment of the financial statements of a reporting undertaking. An example of this is a number of risk disclosures, including disclosures on the way in which the undertaking manages its risks, and information on acquisitions or divestments and contingent liabilities.

Omission of such material risk notes deprives users of material information about the undertaking and thus impairs their understanding of the remaining financial information in the annual report.

⁴ Examples of this type of note are "fixed assets notes" or specification of other payables.

Where this is the case, such omission is considered a misstatement. The same applies to material misstatements or non-disclosure of information in such notes.

In the assessment of materiality of such notes, the type or nature and particular circumstances of the information is generally given the highest weighting. In other words, the qualitative part of the note is an important indicator.

3.8. Control notes

The notes to the financial statements serve various purposes in relation to the users' information requirements. A further sub-category could thus be termed "control notes". By this is meant notes comprising disclosure requirements included in order for shareholders and other users of financial statements to be able to exercise stewardship over those managing or auditing the undertaking. Also characteristic of this type of note is that, in terms of the size of amounts, they are often immaterial relative to the overall materiality level used in assessing any recognition and measurement misstatements in the income statement, for instance. See section 3.3.

The materiality level in the assessment of recognition and measurement misstatements in this type of note must therefore primarily be based on the type/nature and particular circumstances of the disclosure, including the purpose of the note – in other words a qualitative assessment. As the assessment is qualitative, any departures in terms of amounts in such notes should be assessed relative to the importance of the note to users of the financial statements. It follows that the materiality level in terms of amounts in this type of note will be considerably lower than the general materiality level. Even minor departures in such notes may therefore be considered misstatements.

Examples of such control notes are notes on management remuneration, including incentive programmes, and disclosure of the audit fee and its distribution on different types of assignment as well as ownership and related party disclosures.

Omission of such required control notes or misleading information in these seen in relation to their purpose will deprive users of their stewardship instrument, and this is considered a misstatement.