Materiality in the financial statements

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Programme

- Introduction
- Purpose of the financial statements
- What is ‘materiality’
- What are notifications and recommendations
- 44 desktop reviews led to 22 notifications, of which 4 contained a recommendation
- Why did the notifications concern material errors in the financial statements?

Introduction

Materiality in the financial statements is an important subject

- Users no longer accept the black box of the Auditor
- Points of attention in financial reporting of 2010
- Reactions in MAB (monthly for accountancy and business economics) and Accountancy News in first quarter of 2011
- Presentation at the National Financial Reporting Day on 23 June 2011
- ESMA (European Securities and Markets Authority) Consultation document 23 November 2011
- AFM Roundtable Meeting 30 January 2012

Introduction (2)

What next?

- Communication from AFM, why identified errors are material, during the National Financial Reporting Day on 26 June 2012
- Nyenrode Seminar ‘The impact of the public audit’ on 29 June 2012
- ESMA Roundtable Meeting September/October 2012
- ESMA Feedback Statement September/October 2012
- Guidance from IASB and IAASB ???
- Statements from users????

Purpose of Financial Statements under IFRS

Financial statements present fairly:

- Financial position
- Financial performance
- Cash flows

The true and fair view requires the faithful representation of:

- Transactions
- Other
  - Events
  - Conditions

Purpose of Financial Statements under IFRS (2)

An entity achieves a fair presentation if the financial statements:

- Are in compliance with all the IFRS standards
- Contain essential additional disclosures
- Depart from IFRS only in extremely rare circumstances
  - In which application of IFRS would be misleading

Material significance in IFRS

Definition (IAS 1.7)

- The omission or misstatement of items is material if:
  - Individually or collectively
  - This **could** affect the economic decisions of users that they make on the basis of the financial statements
  - Two dimensions of the misstatement are relevant
    - Size of the error
    - Nature

Misstatements that are not material are:

- Not separately presenting immaterial items
- The omission of disclosures that are individually or collectively not material

Notifications and recommendations

Notification

- Written statement from the AFM in which it states:
  - On which part or parts, in its opinion the financial reporting requirements have not been applied correctly; and
  - How the financial reporting requirements in its opinion must be applied in the future.

Notifications and recommendations

Recommendation

- Instruction to publish a press release in which the company explains:
  a. How the financial reporting requirements will be applied in future and the consequences thereof for its financial reporting
  b. Which parts of the financial reporting are not in compliance with the financial reporting requirements and describes the consequences thereof for its finanacial reporting

Reviews of financial statements completed in 2011

- 41 follow up reviews
  - 2 companies received notifications (5%)
- 44 desktop reviews
  - 40 full desktop reviews
  - 4 partial reviews

Completed desktop reviews in 2011

44 reviews of financial statements completed:

- 6 sets of financial statements for 2009
- 38 sets of financial statements for 2010
- Selection on the basis of increased risk of errors in the financial reporting
  - Red flags
  - High risk score
  - Signal (4 times)
- No selection on the basis of rotation

Risk analysis

Elements for determining the risk score:

- Capital market information
- Financial environment
- Governance and structure
- Compliance with other laws and regulations

Breakdown of the financial statements into indices

Funds	Population	Reviews	Notifications	Recommendations
AEX	21	5 (24%)	2 (40%)	1
AMX	24	7 (29%)	1 (14%)	0
AScX	21	6 (29%)	2 (33%)	2
Local	67	18 (27%)	13 (72%)	1
Bond issuers	17	3 (18%)	2 (67%)	0
Foreign	46	5 (11%)	2 (40%)	0
Total	196	44 (22%)	22 (50%)	4

Number of notification per company per standard

Number of notifications per set of financial statements	Number of sets of financial statements
1	7
2 – 3	6
4 – 5	5
6 – 7	2
More than 7	2
Total	22

Identified shortcomings in the financial statements

- No or incomplete disclosure of very material items in the financial statements (8)
- Incorrect classification in primary statements (3)
- Incorrect presentation of the accounting policies(4)
- Inadequate disclosure of tax position (3)
- Miscellaneous items (4)

No or incomplete disclosure of very material items in the financial statements

3 sets of financial statements

- Assumptions used in determining the fair value of investment properties are missing

2 sets of financial statements

- Inadequate sensitivity analysis in combination with optimistic assumptions with impairment testing of an asset (> 30% of total assets).
- Inadequate sensitivity analysis of asset impairment > 50% of balance sheet total

No or incomplete disclosure of very material items in the financial statements (2)

1 set of financial statements

- Assets and liabilities from two very material business combinations are reported in total. The acquired assets are > 25% of the balance sheet total
- The one BC led to the capitalisation of goodwill, while the other resulted in a profit in connection with negative goodwill

1 set of financial statements

- The exceptional items included a non-recurring item with a negative effect on the result amounting to 20% of the result
- A large non-recurring item with a positive effect on the result is missing

1 set of financial statements

- Quantitative reconciliation between segment information and the income statement is missing. Segment information is twice as large as the revenue reported in the income statement

Incorrect classification in primary statements

3 sets of financial statements

- Part of financial instrument was wrongly presented as equity. Item concerns approximately 30% of the equity

- One operating cash outflow was erroneously reported in another cash flow. This turned the large positive operating cash flow into a small negative operating cash flow

- A long-term provision was incorrectly recognised under the current liabilities. The timing and amount of the payment are uncertain, but will not take place within 12 months. Provisions were more than 30% too low and current liabilities approx. 10% too high

Incorrect presentation of the applied accounting policy

4 sets of financial statements

- The reported accounting policy for revenue recognition was not in accordance with IFRS and also deviated from the applied accounting policy

- The retrospective restatement of a material prior period error was reflected as a change in accounting principles. Comparative profit decreased by more than 5%

- One company did not provide any segment information. There was only one reporting segment. The disclosure reported an entirely different (invalid) reason, whereby the impression was created that there was more than one reporting segment

- It was unclear whether the separate financial statements were prepared on the basis of Part 9, Book 2 of the Netherlands Civil Code or IFRS. One of the applied measurements did not comply with any of both systems

Inadequate disclosure of the tax position

3 sets of financial statements

- The convincing evidence that justifies the inclusion of the deferred tax asset was missing. DTA amounts to 10% of fixed assets and almost 10% of equity

- Company has low profitability

- Nature of the convincing evidence that justifies the inclusion of the deferred tax asset was missing. Company has been making heavy losses for 2 years and operates in a sector in which prices and results are under pressure and capitalises the losses completely

- The reconciliation between the applicable rate and the actual tax burden does not reflect the structural and incidental causes of the deviations

Miscellaneous items

4 sets of financial statements

- Termination fee at premature termination of tenancy agreement recognized over the remaining term of the terminated contract

- Qualification was included in auditor's report

- The share-based payments of key management is not reported in the disclosures. Costs are approx. 50% of the remuneration

- Cash and cash equivalents item is >20% of balance sheet total, of which a large proportion is valued at amortised cost. In overview of financial instruments on basis of fair value, they are included in level 1 and level 2 columns
- This raises questions in Company reporting

- Emission costs of 5% of the result was incorrectly incorporated in income statement

Summary and conclusion

- Material significance in the financial statements is an important current subject
- Some errors are caused by differences of opinion concerning the application of IFRS
- At least one notification per set of financial statements refers to a material error
- 2/3 of the companies have received notifications as a result of several errors
- The number of notifications amounts to an average of 3.3 per set of financial statements