Market Newsletter 2/2021

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Discussion on sustainability reporting – Erkki Liikanen, Chair of the IFRS Foundation Trustees, discussed the launch of global standards for sustainability reporting

Erkki Liikanen.
Photo: Financial Supervisory Authority.

Sustainability reporting standards must be globally applicable in all industries. **Erkki Liikanen**, Chair of the IFRS Foundation Trustees, also urges market participants to familiarise themselves with the published prototypes of the standards and to assess whether they are clear and can be truly interpreted in a similar way globally.

On 19 November 2021, the Financial Supervision Authority (FIN-FSA) organised a discussion on sustainability reporting for stakeholders. The theme of the event was Sustainable Development and Reporting Standards following the COP26 Climate Summit in Glasgow. Erkki Liikanen, Chair of the IFRS Foundation Trustees, made an introductory statement. In her opening remarks, Head of Division Tiina Visakorpi said that harmonisation of sustainability disclosures at the global level – in addition to European regulations – is essential in order to facilitate investors' decisions.

Significant announcements at the Glasgow Climate Summit

In his introduction, Liikanen spoke about the IFRS action plan and the progress made in the field of sustainability reporting. At the Glasgow COP26 Climate Summit in November, the IFRS Foundation announced **three major decisions** with regard to the development of global sustainability reporting. The **first** of these was formation of the International Sustainability Standards Board (ISSB).

The ISSB sits under the IFRS Foundation and operates as an independent sister organisation of the International Accounting Standards Board (IASB), which develops and approves International Financial Reporting Standards (IFRS). The decision to place the ISSB under the IFRS Foundation was preceded by a global consultation. One issue on which the views of market participants was sought was the possible role of the IFRS Foundation in the global development of sustainability reporting. Placing the ISSB under the Foundation attracted wide support, as the Foundation has existing operating principles, a transparent governance model, processes that consult market participants in the preparation of global standards, and is operationally independent.

The ISSB is tasked with developing a set of global standards to ensure the provision of comparable and transparent sustainability disclosures. The focus is on meeting investors' information needs with regard to the risks and opportunities in the different areas of sustainable development.

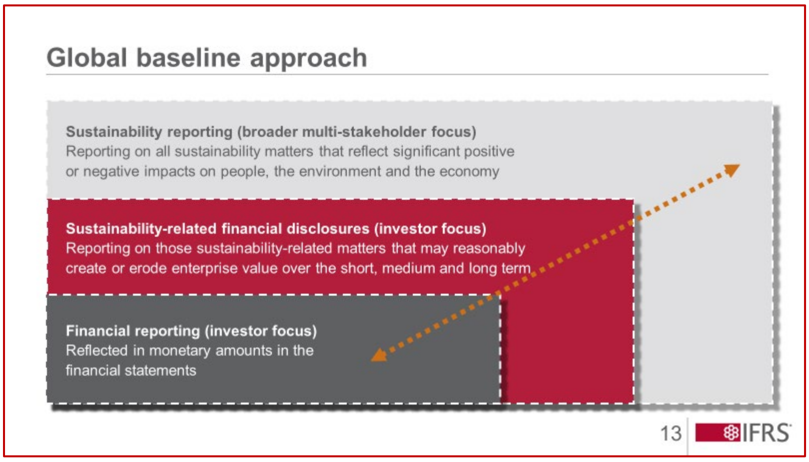
The **second major decision** was to consolidate within the ISSB the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (VRF), which have operated globally in the field of sustainability reporting. According to Liikanen, this was considered the most significant achievement in Glasgow in terms of global development work. The Sustainability Accounting Standards Board (SASB), which had previously issued responsibility standards, and the International Integrated Reporting Council (IIRC), which had published an integrated reporting framework, had earlier been merged with the VRF.

The **third major decision** was the publication of prototype standards on general and climate-related sustainability disclosures. These are proposals prepared for the ISSB by the Technical Readiness Working Group (TRWG) to accelerate the start of the ISSB's work. The ISSB will consider including them in its work programme.

In practice, with the establishment of the ISSB, comparable and informative IFRS reporting for listed companies will be expanded into a set of global reporting standards in two different areas. Alongside the current IFRS for financial reporting, there will be IFRS for sustainability reporting.

Basis of the ISSB's work

The ISSB's regulatory approach is to establish a *global baseline* of sustainability-related financial disclosures to ensure comparability of information from the investor's perspective (*investor focus*). In addition, jurisdictions may, where necessary, increase requirements for sustainability disclosures, taking into account the needs of other stakeholders (*broader multi-stakeholder focus*).



Source: IFRS Foundation

As a structure for the IFRS sustainability reporting standard, the TRWG proposes a model in which, in addition to general requirements, there are both thematic and industry-specific reporting standards, each based on company-specificity and the company's own materiality assessment. Liikanen emphasised the importance of stakeholders in consulting on industry-specific standards in order to make them globally applicable in each industry.

In its regulatory work, the ISSB will first focus its regulatory work on the climate-related theme, as there is a political consensus on this on the basis of the Paris Climate Conference. As to what theme will come next in the ISSB's work programme, the views of market participants are expected in connection with the ISSB's first agenda consultation.

The organisation of the ISSB is currently under way and will be geographically extensive in terms of representation. The main offices will be in Frankfurt and Montreal, in addition to which complementary offices will also be established in London and San Francisco. The opening of offices in Beijing and Tokyo is also being discussed.

The IFRS Foundation hopes that market participants will familiarise themselves with the published prototypes of the standards and assess whether they are clear and can be truly interpreted in a similar way globally. The ambitious goal is to complete and publish the first standard during 2022.

Discussion based Erkki Liikanen's introduction

All those who spoke warmly congratulated the IFRS Foundation on its concrete progress in building global sustainability reporting. Among the contributors, those who had long been involved in sustainability reporting stated that common global standards – instead of the many previous different frameworks – are a major step forward. The IFRS Foundation's existing structures and the utilisation of current processes were considered to be sensible. These were recognised as promoting the rapid launch of work and the achievement of results.

There was also discussion about how to involve all continents and markets, which are at very different stages of development with regard to sustainability issues, in applying sustainability reporting standards. Liikanen stated that issues like the climate are such that there is a very strong desire to keep everyone involved in harmonised development. Moreover, in the future, pressure to adopt global standards will be exerted on all market participants via the market once the use of the standards begins and comparability is achieved. This will also promote the adoption of the standards in markets, such as emerging markets, where IFRS, for example, are not widely used.

The discussion event focused on the development of a global set of standards, but also touched upon the ongoing preparation of European sustainability reporting standards. The compatibility of European and global requirements was addressed. It was noted that in European regulations, the requirements of the ISSB standards are also expected to be the starting point from which the EU prepares its own additional requirements in accordance with the *baseline* model described above.

The content and timetable for EU legislation on sustainability reporting was discussed in the FIN-FSA's Sustainable Finance webinar on 29 September 2021. The presentation material is available on FIN-FSA's website (in Finnish).

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Investment discussion on social media

Over the past year, the FIN-FSA has received more contacts concerning investment discussions and writing on social media. The contacts and enquiries have related to, among other things, when social media discussion may involve price manipulation, when a social media discussion may be considered to give an investment recommendation, and what investors should pay attention to in social media discussions. The purpose of this article is to clarify regulations related to this topic and also to provide practical guidance on how to act on social media.

Functioning of securities markets requires common ground rules

A requirement for the functioning of the securities markets is that investors can have confidence in the markets and market participants. Abuses, such as misuse of inside information and market manipulation, erode this confidence. The Market Abuse Regulation (MAR), which entered into force in all EU countries on 3 July 2016, regulates market abuse, i.e. insider trading and market manipulation, for example, and also production of investment recommendations.

The FIN-FSA monitors compliance with MAR with regard to Finnish securities. The FIN-FSA evaluates social media writing, particularly from the perspective of price manipulation and investment recommendation regulations.

What is manipulation and what can follow from it?

Increased interest in investing has also increased discussion on social media. Discussion about stocks and investing is positive and important. When presenting opinions and views, however, the prohibition of manipulation must be taken into account.

There are several forms of market manipulation, but a key aspect of manipulation is that the perpetrator misleads others with their own actions. Market manipulation may, for example, be the dissemination of misleading or completely false information with the goal of influencing the price of a share. In assessing misleading information, account may be taken, for example, of how accurate the disseminated information is and its relevance in relation to the value of the share. The prohibition of manipulation applies to everyone, but the party disseminating the information may also be relevant in assessing how misleading the information is.

A person presenting themselves as an investment industry professional may, for example, make misleading purchase recommendations in an effort to raise the price of a share, or a person profiled as an investment industry expert may present a company's future positive result as certain information. The prohibition of market manipulation applies to everyone, including private individuals, and breaches of the prohibition are punishable under criminal law. The FIN-FSA reviews suspected cases of manipulation that come to its knowledge and makes requests for investigation to the police where the investigation of cases reveals that there is reason to suspect a crime.

What is production of an investment recommendation and what can follow from it?

The provisions related to investment recommendations mainly apply to professional analysts. The provisions also apply, however, to other people who, on social media or otherwise, repeatedly propose investment decisions and present themselves as financial experts. The content and the targeting of a recommendation are important, for example the making of buy, sell and hold recommendations to the public.

Investment recommendations must be presented impartially and transparently. In terms of impartiality, it is important in an investment recommendation to separate one's own opinions and views from the facts. Transparency requires disclosure of factors that undermine the impartiality of a recommendation. In connection with a recommendation, the party making the recommendation must disclose any holdings and conflicts of interest related to the share that is subject to the recommendation.

Violation of the above-mentioned requirements of the investment recommendation regulations may result in an administrative penalty payment imposed by the FIN-FSA. Investment recommendations may also be assessed as possible market manipulation if they would be misleading in the manner discussed above in connection with manipulation.

How should one act on social media?

1. Conduct discussions with other investors on different social media channels based on public information and justifying your own points of view.
    - In this way, you contribute to improving market transparency and, particularly in the case of small and less monitored companies, to increasing awareness of them as potential investment objects.
2. Familiarise yourself with the investment object as carefully as possible before making a final investment decision.
    - You will significantly reduce your risk of making an ill-considered and potentially unprofitable investment. Ultimately, you are responsible for your own investment decisions.
3. Remember source criticism – on social media, you can never know completely what the real interests of each writer are.
    - You will significantly reduce your risk of making an ill-considered and potentially unprofitable investment.
4. Remember that knowingly disseminating misleading and incorrect information is prohibited.

- If you notice on social media the dissemination of misleading investment information, you may report the matter to the FIN-FSA. It will be possible to investigate the matter more thoroughly if the report contains sufficiently specific information about the suspected event (what, where, when, who). Screenshots of the discussion, for example, can be submitted as attachments to the report.
- The FIN-FSA may make a request for investigation to the police if the investigation of the matter reveals grounds to suspect market manipulation.

More on this topic

- Report suspected abuse to the FIN-FSA
- 17 February 2021: ESMA highlights risks to retail investors of social media driven share trading
- Bank of Finland Museum lecture 11 May 2021: Trading from the perspective of market manipulation – Where can the small investor run into problems? (in Finnish) Discussion on the social media was addressed at the end of the presentation.
- 28 October 2021: ESMA's Statement on Investment Recommendations on Social Media
- Market Abuse Regulation (EU) No 596/2014

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IFRS Enforcers conducted studies on credit risk disclosures of financial institutions

The European Securities and Markets Authority (ESMA) has conducted a Europe-wide study on the application of the (IFRS 7[1] and IFRS 9[2]) requirements regarding banks' expected credit losses (ECL). In the study, ESMA and European financial statement enforcers reviewed the 2020 disclosures on credit risks and impairments of 44 financial institutions. The objective was to provide an overview of compliance with standards, the transparency of disclosures, and comparability.

Enforcers examined information disclosed on the following key areas:

- general aspects of the ECL disclosures
- assessment of a significant increase in credit risk (SICR)
- consideration of forward-looking information
- expected credit losses
- transparency of disclosures on credit risk
- sensitivity analyses.

ESMA published a report on the study "Report on the application of the IFRS 7 and IFRS 9 requirements regarding banks' expected credit losses (ECL)". The report contains the requirements of the standards, findings made on the financial statements, ESMA's recommendations, and examples of disclosures.

[1] IFRS 7 *Financial Instruments: Disclosures*.
[2] IFRS 9 *Financial Instruments*.

Using ESMA's methodology, the FIN-FSA reviewed the IFRS financial statements for 2020 of ten Finnish banking groups (hereinafter financial institutions). In its study, the FIN-FSA focused on some of the areas of the application of IFRS 7 and IFRS 9 that ESMA examined in its own study. This article contains the FIN-FSA's findings regarding disclosures on significant increase in credit risk, scenarios, reconciliation of expected credit losses, adjustments to the ECL model, and assets modified in terms of their cash flows. In addition, the article compares the findings of the two studies, where applicable. In the comparison, it should be noted that the ESMA study includes a wider sample of banks of different sizes across Europe.

The FIN-FSA found that most Finnish financial institutions disclosed information on credit risks and expected credit losses on a fairly general level. Credit risk disclosures should, however, be sufficiently detailed to enable the user of the financial statement to assess the nature and extent of credit risks and to form an overall picture of the financial institution's exposure to credit risks. The FIN-FSA expects financial institutions to take the findings presented in this article into account when developing their credit risk disclosures.

Nature and extent of financial risks must be disclosed

Under IFRS 7.1, users of financial statements must be able to evaluate, on the basis of the information they receive from the financial statements, the significance of financial instruments for the entity's financial position and performance.

The requirements for credit risk disclosures are set out in paragraphs 35A-38 of IFRS 7 and its application guidance (Appendix B). In addition, the disclosure of credit risks must, in accordance with IFRS 7.31–35, comply with all requirements for risks arising from financial instruments. Based on these paragraphs, an entity shall disclose quantitative and qualitative information that enables users of its financial statements to evaluate the nature and extent of the risks arising from financial instruments and how the entity manages these risks. Qualitative and quantitative information must enable the reader to form an overall picture of the entity's exposure to financial risks and the management of these risks.

According to the FIN-FSA's findings, financial institutions do not always provide sufficient quantitative information to enable the evaluation of the overall picture and the nature and extent of credit risks arising from financial instruments. Quantitative information has a key role, particularly when the reader evaluates, on the basis of the financial statements, the significance of financial instruments for the financial institution's financial position and performance. Crucial information includes criteria for a significant increase in credit risk, the amounts of financial assets and their impairment at different stages of the impairment model, and information describing the nature and extent of assets, such as the amount of forborne exposures.

IFRS 7 contains quite a number of disclosure requirements, and therefore it might be difficult to form a bank- and risk-specific overall picture on the basis of detailed information (IAS 1.7, IFRS 7.35D-35E). An overall picture and significant factors affecting credit risks and their management could be presented more clearly by explaining the risk-specific overall picture as well as the most significant figures for the financial year and their backgrounds in connection with each disclosure.

Disclosures on the assessment of significant increase in credit risk (SICR) are not sufficiently detailed

According to IFRS 7.35F, an entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective, the standard lists *the required disclosures. In addition, the entity shall explain the basis of inputs and assumptions, and the estimation techniques that the entity has used as indicators of a significant increase in credit risk (IFRS 7.35G).*

The FIN-FSA's study found that the financial statements of financial institutions did not always clearly indicate whether a significant increase in credit risk is measured on an individual or collective basis and how financial assets were grouped for the assessment of SICR on a collective basis. In addition, the technique used for assessment of SICR on a collective basis should be explained in sufficient detail to enable the reader to understand the impact of SICR on expected credit losses. According to ESMA's study, financial institutions were more successful in presenting this information.

Based on the financial statements, six Finnish financial institutions estimated significant increase in credit risk using, at least as one factor, relative change in PD[3] of an exposure or customer (PD at reporting date relative to PD at initial recognition). Four financial institutions reported that they use lifetime PD and two financial institutions 12-month PD. Of the financial institutions that reported that they use relative change in PD, only half reported a quantitative threshold for the indicator in their financial statements. ESMA's study found a similar result.

According to ESMA's study, 80% of financial institutions used forbearance measures as an SICR indicator. Of the Finnish financial institutions, nine reported that they use granted forbearance measures as an SICR indicator.[4]

A number of Finnish financial institutions reported that they had granted grace periods in 2020. Financial institutions reported in the annual report or the board of directors' report that not all of the grace periods were recorded as forborne exposures. Despite this, only three financial institutions in the survey mentioned the matter in their financial statements, without providing detailed information, however. Based on these findings, it might have been impossible for the reader to understand the relationship between grace periods and forbearances as well as possible changes in SICR indicators in 2020. The FIN-FSA found that the SICR information disclosed by a number of Finnish financial institutions was on a fairly general level. In the ESMA survey, around 30% of financial institutions reported in detail the changes made to SICR indicators due to the pandemic.

Differences in probability weights of financial institutions' scenarios

IFRS 7.35G(b) requires an entity to explain how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information.

Six of the Finnish financial institutions reported that they used scenarios in the determination of expected credit losses. Most commonly, financial institutions in Finland use three scenarios, the lengths of which vary, according to the financial statements, from 3 to 10 years. None of the Finnish financial institutions reported that they had changed the length of the forecast period of scenarios due to the COVID pandemic. Five financial institutions clearly indicated that they also use scenarios to estimate significant increase in credit risk, whereas the use of scenarios remained unclear with regard to the other five financial institutions.

Of the six financial institutions that reported that they use scenarios in determining expected credit losses, four (67%) reported the probability weights they used in the scenarios. In ESMA's study, 83% of financial institutions that reported using multiple scenarios reported the weighting of the scenarios.

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[3] Probability of default.
[4] ESMA has clarified the treatment of forbearances under IFRS 9 in its 2019 enforcement decision.

The FIN-FSA's study found that the probability weights of the scenarios of the Finnish financial institutions differed significantly. The weights of the baseline scenario ranged from 40% to 60%. Correspondingly, the range in the probability weighting of the adverse scenario was 2%–50% and the range of the favourable scenario was 5%–40%. In ESMA's study, the financial institutions' most commonly used weights were 20%–25% for the adverse scenario and 10%–20% for the favourable scenario. The COVID pandemic was taken into account in scenarios either by changing the weights or by changing the values of the macroeconomic variables in the scenarios, or both.

The FIN-FSA considers that the large variations in the weights of financial institutions' scenarios for the near future to be surprising, given that Finnish financial institutions are evaluating the outlook for the same economic area. In the FIN-FSA's opinion, the differing views of banks about the near future constitute a good example of information about which financial institutions are required to provide sufficiently detailed disclosures as well as explanations of the judgment they exercise to enable the reader to assess the nature and extent of credit risks to which the financial institution is exposed. Few financial institutions had provided in their financial statements any more detail than a general statement about the estimates affecting the determination of scenario weights.

Reconciliation of expected credit losses should be clearly disclosed

IFRS 7.35H requires, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, and disaggregated as required by the standard. In addition, the entity shall explain the changes in the loss allowance and the reasons for those changes.

A number of financial institutions presented a reconciliation of the loss allowance, but there are qualitative differences between financial institutions in the manner of presentation of the reconciliation. Most of the financial institutions disclosed loss allowance events according to impairment model stages, disaggregated by asset category or as a combination of the aforementioned. ESMA identified development needs in the content of the reconciliation and in the description of events and changes.

IFRS 7.35I requires an entity to explain how significant changes in the gross carrying amount of financial instruments contributed to changes in the loss allowance. The disclosures shall include relevant quantitative and qualitative information. IFRS 7.IG provides examples of the application of the credit risk disclosure requirements of the standard.

Only half of the financial institutions in the study disclosed significant changes in the gross carrying amount of the loss allowance reconciliation, combined with information on the changes that occurred in the loss allowance. In ESMA's report, the result was slightly better, but based on the findings, the financial statements contain information on a fairly general level.

IFRS 7.35L requires an entity to present the contractual amount outstanding on financial assets that were written off during the reporting period and are still subject to enforcement activity.

Half of the Finnish financial institutions reported their contractual amounts that were written off but are still subject to recovery measures (enforcement activity). Of the financial institutions included in ESMA's study, only around 30% reported this.

Based on the FIN-FSA's study, financial institutions should pay attention to the clarity and unambiguity of the items presented in the reconciliation of the loss allowance. For some financial statements, this means developing the reconciliation in more detail and, for some financial statements, opening up the content of the terms used in connection with the reconciliation. Adding or revising verbal descriptions will improve comprehensibility and clarity. ESMA's study also contains similar findings.

In addition, the FIN-FSA drew attention to the fact that the financial statements of the financial institutions did not always disclose clearly the total amount of final credit losses recorded during the financial year and the total amount of unrealised expected credit losses.

Adjustment to expected credit loss model based on management judgment (so-called management overlay)

IFRS 7.35G requires an entity to explain the inputs, assumptions and estimation techniques used in the determination of impairments. IFRS 7.35G(c) requires, in particular, an entity to explain changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

IAS 1.122 requires an entity to disclose the judgments that management has made that have the most significant effect on the amounts recognised in the financial statements. Under IAS 1.125, an entity shall disclose the key assumptions concerning the future and other key sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. IAS 1.125 and IAS 1.129 require disclosures.

According to the FIN-FSA's findings, three financial institutions reported clearly that they had taken into account the impact of the COVID pandemic on impairments by adjusting, based on management judgment, the amount of expected credit losses generated by the ECL model (management overlay). These financial institutions also reported the euro amount of the adjustment based on management judgment. Two financial institutions reported that they had not made an adjustment. For five financial institutions, the issue was not mentioned or remained unclear. In the European study, the impairment resulting from the expected credit loss model was adjusted on the basis of management judgment in 80% of financial institutions.

In view of the exceptional situation in 2020, the FIN-FSA considers that, in the determination of impairments based on management judgment, there was significant information that entities would have been required to disclose clearly in the financial statements with regard to credit risk and the overall picture of its management. If adjustments based on judgment are made, there should be disclosures on them.

Disclosures on the nature and extent of assets are important for users of financial statements

IFRS 7.33–38 contains a number of disclosure requirements related to the nature and extent of assets.

With regard to modifications of contractual cash flows on financial assets (including forborne exposures), an entity shall disclose, in accordance with IFRS 7.35I and IFRS 7.35J, information on changes in the loss allowance and on the amounts of the exposures.

The significance of grace periods, various other reliefs and support measures for the key figures of financial institutions was particularly important information for many users of financial statements in the exceptional circumstances of 2020. With regard to forborne exposures and other financial assets modified in terms of their cash flows, an entity must disclose information on the carrying amounts of the modified assets. The FIN-FSA's study revealed that that only three financial institutions disclosed in some respects the quantitative information required by the standard. The study also included financial institutions that did not disclose any or little information on exposures and financial assets that had been subject to forbearance. ESMA's study also highlighted the fact that only 47% of European financial institutions provided comprehensive disclosures on the treatment of forbearance.

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Role and practices of audit committees subject to European Commission consultation and evaluation by auditing oversight bodies

The importance of audit committees in ensuring high-quality corporate reporting has been further emphasised as a result of the Wirecard corporate scandal. In November 2021, the European Commission published a public consultation document entitled "Strengthening of the quality of corporate reporting and its enforcement", one theme of which is the possible need for changes in the role and duties of audit committees.

The Committee of European Auditing Oversight Bodies (CEAOB) regularly prepares audit committee questionnaires at EU level to assess the activities of audit committees. The most recent questionnaire, in summer 2021, surveyed the views of audit committees on the materiality applied in financial reporting and in auditing. Audit committees have an important role to play in monitoring and overseeing the application of materiality, as materiality is to a large extent a discretionary factor and the level of materiality selected affects the quality and reliability of the information provided to investors.

The FIN-FSA is the competent authority responsible for monitoring and assessing the performance of audit committees, whereas the Finnish Patent and Registration Office (PRH) is responsible for audit-related market monitoring tasks. The PRH is also a member of the CEAOB. The PRH implements the CEAOB questionnaires in Finland on the basis of their content, either alone or in cooperation with the FIN-FSA. The European Commission encourages supervisors to engage in an ongoing dialogue with audit committees.

Audit committee questionnaire on the materiality applied in financial reporting and in auditing

The audit committee questionnaire is part of a broader CEAOB thematic review, which aims to give users of financial statements a better understanding of materiality and how it affects the planning and performance of audits. The thematic review also surveys the views of the audit committees on the materiality of financial reporting and the materiality applied by the auditor.

Implementation of the questionnaire

In the first stage of the thematic review, audit firms provided the PRH with information on materiality calculation principles in accordance with audit methodology. In addition, the PRH randomly selected 30 public interest entities, whose auditors were requested to provide information on the materiality thresholds used in the audits. In the second stage of the thematic review, the entities' audit committees were asked for their views on the materiality of financial reporting and the audit. Most of the questions in the audit committee questionnaire concerned the materiality applied by the auditor. The response rate to the audit committee questionnaire was 77%.

The CEAOB will publish the EU-level results of the audit committee questionnaire in a separate report in 2022. The Irish Auditing & Accounting Supervisory Authority announced the preliminary results of the questionnaire at an event in October.[5] They were similar to the results in Finland. The Financial Supervisory Authority of Norway (Finanstilsynet) published a detailed report on the results of the materiality questionnaire. One of the findings of the report is that few audit committees have paid attention to how the auditor's materiality thresholds affect the nature and extent of the audit and the auditor's reporting.[6]

Materiality framework – the role of audit committees in monitoring the application of materiality

In financial reporting, materiality is a key concept in assessing whether the financial statements as a whole have been prepared correctly or whether a particular accounting treatment is acceptable or whether it gives an incorrect picture. The definition of materiality in financial reporting is not unambiguous and general limiting conditions cannot be set. The European Securities and Markets Authority (ESMA) expressed its views on materiality after an extensive consultation. The FIN-FSA was involved in the preparation of the feedback statement and wrote an article on the subject in Market newsletter 1/2013 (in Finnish).

In IFRS reporting, the assessment must be made from the perspective of the investor's decision-making, in particular. The determination of materiality requires an overall assessment, taking circumstances into account and careful consideration. Both quantitative and qualitative factors should be taken into account in the assessment. Materiality cannot therefore be assessed only quantitatively, for example by relating the item under examination to profit or equity. Furthermore, according to ESMA, there are situations where assessing the materiality of the information provided is particularly sensitive. In that case, the materiality threshold might be lower.

The assessment of materiality is also one of the key considerations requiring the exercise of judgment in an audit. The correct level of materiality is essential for the success of an audit. In an audit, materiality is determined from the perspective of all users of the financial statements. Materiality is used to detect misstatements and may be applied to one item or to several items together. Moreover, in an audit, materiality is not only determined quantitatively; qualitative factors related to the needs and expectations the users of the financial statements should be the overriding consideration.[7]

Audit committees have an important role to play in monitoring and overseeing the determination of materiality, as the level of materiality selected directly affects the quality and reliability of the information provided to investors. For this reason, among others, the auditors must report to audit committees on the materiality used in the audit. According to the EU Audit Regulation, the auditor shall submit to the audit

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[5] *IAASA Audit Committee Briefing (2021): Audit Quality Unit*
[6] *Tematilsyn - Revisjonsutvalg og revisors vesentlighetsgrenser (2021)*
[7] *Audit Quality Thematic Review: Materiality (2017)*

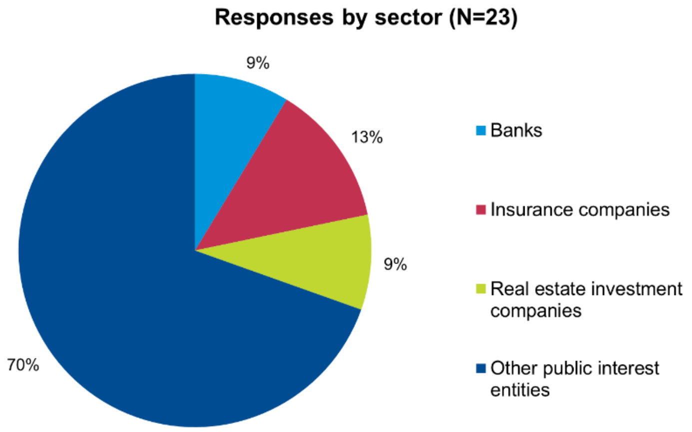
committee a detailed additional report[8] on the results of the statutory audit. The additional report shall disclose, among other things:
- the quantitative level of materiality applied to perform the audit for the financial statements as a whole;
- where applicable, the level or levels of materiality applied to particular classes of transactions, account balances or disclosures; and
- the qualitative factors that were considered when setting the level of materiality.

In its 2017 annual report on quality assurance, PRH Auditor Oversight reported its findings related to the materiality of audits, which may also be useful information for audit committees.[9] The findings cover, among other things, overall materiality, performance materiality, specific materiality and revision of materiality.

Results of the audit committee survey with regard to Finnish companies

The FIN-FSA analysed the responses to the above-mentioned CEAOB audit committee questionnaire with regard to Finnish companies. The findings and charts presented below are based on the FIN-FSA's analysis of questions selected by the FIN-FSA and therefore do not cover all of the material in the questionnaire.

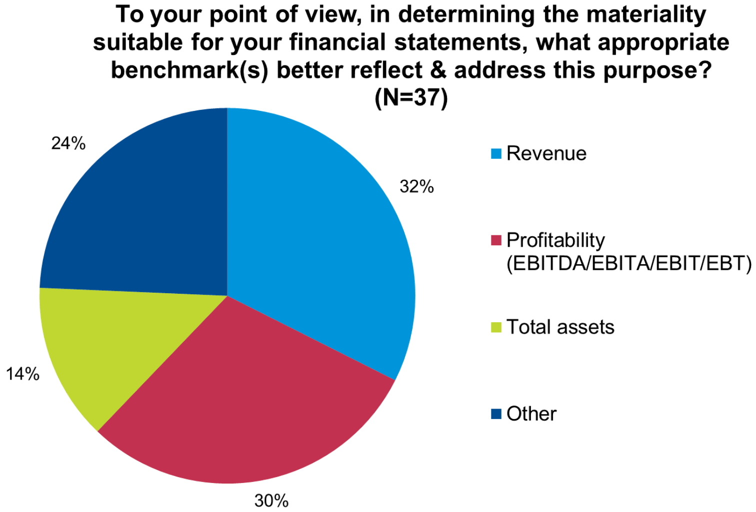
Figure 1: Responses to the audit committee questionnaire by sector.



Source: Financial Supervisory Authority

[8] *Regulation (EU) 537/2014 of the Council and of the European Parliament, Article 11.*
[9] *PRH Auditor Oversight's Annual Report on Quality Assurance 2017 (in Finnish)*

Figure 2. Financial statement items used in the assessment of materiality



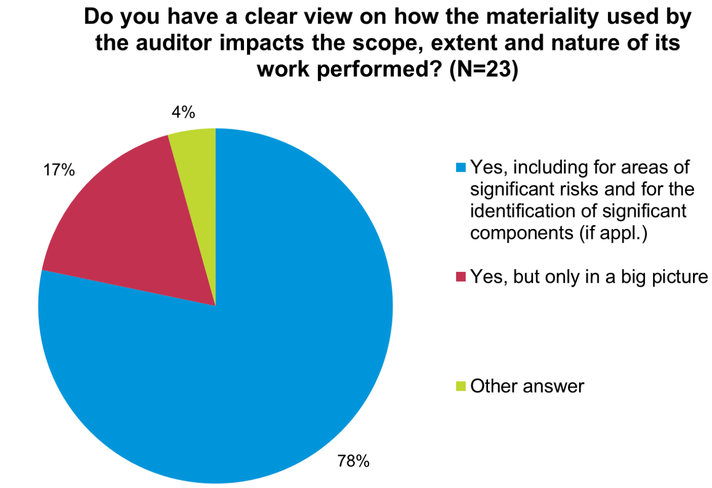
Source: Financial Supervisory Authority

The Figure 2 results are presented only for sectors other than the banking, insurance and real estate investment sectors. The responses of these sectors are related to their special characteristics.

The audit committees were asked about the financial statement items on the basis of which they assessed the materiality of the financial statements. In their responses, the companies named 1–3 financial statement items. The most common answers in Finland were revenue (32%), profitability (30%) and total assets (14%). The answer “Other” was made up of number of different factors. (see Figure 2)

The audit committees were also asked to indicate the percentage of misstatement above which they consider the financial information to be materially misstated for the items they named. The average percentage for revenue was 1%, the average percentage for profitability was 6% and the average percentage for total assets was 1%. The audit committees were also asked whether it would be appropriate to set a lower level of materiality for a specified financial statement line item or disclosure. A small proportion (13%) of the audit committees answered in the affirmative.

Figure 3. Audit committees’ views on the materiality used in the audit



Source: Financial Supervisory Authority

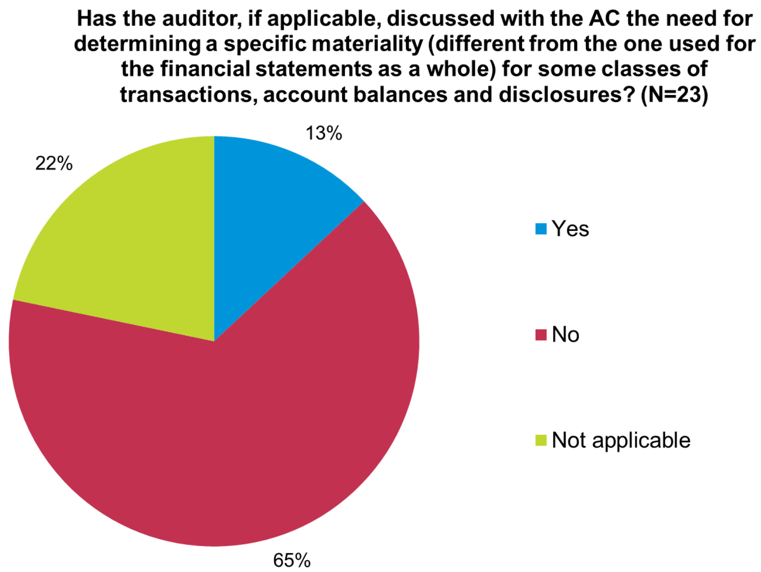
The audit committees were asked whether they had a clear view of how the materiality used by the auditor impacts the auditor's work. The most of the audit committees (78%) answered in the affirmative, while less than a quarter (17%) said they had a view, but only in a big picture. (see Figure 3)

In Finland, all audit committees (100%) were satisfied with the level of materiality used by their auditors.

Determining materiality requires the auditor to exercise professional judgment. In determining materiality for the financial statements as a whole, a percentage is often applied to a chosen benchmark as a starting point.[10] Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities.[11]

The audit committees were asked whether the auditors had explained to the audit committee the auditor's professional judgment about the choice of a benchmark as a starting point for determining materiality for the financial statements as a whole. Most of the audit committees answered in the affirmative (87%).

Figure 4. Discussions between audit committee and auditor on specific materiality



Source: Financial Supervisory Authority

The questionnaire also included a number of questions on what the auditor had discussed with the audit committee regarding materiality. Figure 4 presents the answers to the question on whether the auditor had discussed the need to determine a specific materiality other than materiality use for the financial statements as a whole. Auditing standards describe situations in which this may be necessary.[12] More than half of the audit committees (65%) answered this question in the negative, less than a fifth (22%) did not consider it applicable and a small proportion (13%) answered in the affirmative.

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[10] *ISA 320.A4*
[11] *ISA 320.A5*
[12] *ISA 320.10*

The questionnaire also included a question on whether the auditor had communicated to the audit committee about the materiality threshold used when reporting unadjusted audit differences. Most of the audit committees (65%) had already been informed of this at the planning stage of the audit, while less than a quarter (18%) were not informed of this until the time of reporting the audit findings. A small proportion (13%) replied that the auditor had not communicated this to the audit committee.

The FIN-FSA considers the determination of materiality to be a challenging area of financial reporting and auditing. Audit committees could potentially discuss materiality with the auditor even more extensively than at present, for example, with regard to different levels of materiality, the professional judgment exercised by the auditor in determining materiality, and the materiality threshold used when reporting unadjusted audit differences.

CEAOB finalising extensive audit committee survey

In addition to the thematic questionnaire on materiality, the CEAOB is currently finalising an extensive audit committee survey.[13] In Finland, the PRH will send the CEAOB survey to randomly selected audit committees in late 2021/early 2022. This survey is reminiscent of the CEAOB's first survey, which the FIN-FSA conducted in 2019 in collaboration with the PRH. More information about Finland's results can be found in the FIN-FSA's and PRH's nearly 100-page Report of the Audit Committee Survey[14] and in the EU-level results of the CEAOB's analysis.[15]

The surveys are based on self-assessments of audit committees and thus provide a limited picture of the activities of audit committees. The Commission will assess possible ways to improve the capacity of national competent authorities to carry out their task of monitoring and assessing audit committees.[16]

European Commission evaluating role of audit committees

In November, the European Commission published a public consultation document "Strengthening of the quality of corporate reporting and its enforcement". The Wirecard corporate scandal has also contributed to creating a need to review the corporate reporting structure. The aim of the consultation is to remedy shortcomings in the operating environment, enhance investor protection and increase the attractiveness of the capital markets union. The results of the consultation will be taken into account in an impact assessment to be made next year, in which current EU rules may be amended and strengthened. The Commission requests replies by 4 February 2022.

The three pillars of corporate reporting are: corporate governance, statutory audit and supervision. Together, the three pillars contribute to the high quality and reliability of reporting. Weaknesses in one pillar also have a negative impact on other pillars.

The consultation is divided into five parts:
1. the EU framework for high quality and reliable corporate reporting
2. corporate governance
3. statutory audit
4. supervision of statutory auditors and audit firms
5. supervision and enforcement of corporate reporting.

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[13] *Under the EU Audit Regulation, competent authorities shall regularly monitor the developments in the market for providing statutory audit services to public-interest entities and shall in particular assess, among other things, the performance of audit committees (Commission's Market Monitoring Report).*
[14] *Report on the Audit Committee Survey (2020)*
[15] *CEAOB Analysis on Audit Committee indicators collected as part of the 2nd Market Monitoring report (December 2020)*
[16] *Conclusions in European Commission 2021 report on developments in the EU market for statutory audit services to public-interest entities pursuant to Article 27 of Regulation (EU) No 537/2014.*

The purpose of the second part of the consultation is to obtain feedback in particular on the functioning of company boards, audit committees and views on how to improve their functioning. The consultation includes a number of questions related to audit committees. For example, respondents are asked to assess whether the following measures would increase the quality and reliability of corporate reporting on a scale of 1 to 5:

- Require proper expertise of specific board members in relation to corporate reporting, e.g. internal controls, accounting framework, sustainability reporting.
- Remove exemptions in EU legislation for establishing an audit committee.
- Increase the tasks of the audit committee, e.g. for providing assurance on internal control systems for the avoidance of fraud, among other things.
- Strengthen the external position of the audit committee (e.g. by reporting to shareholders).

More information for audit committees, see the FIN-FSA's online service

A section, Audit committees and auditing, where the FIN-FSA has gathered relevant audit committee information generated in connection with supervision, has been established on the FIN-FSA's website. The section does not cover specific issues regarding prudential supervision.

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