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MEMO

To	CDM EB UNFCCC Secretariat
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Subject	**Memo on Materiality**

Discussion Paper on the Application of Materiality in CDM

What is materiality?

Materiality is a widely accepted approach in accounting and verification auditing schemes. In fact, “Materiality” is one of the nine principles identified in Generally Accepted Accounting Principles (GAAP) [1] and it is identified as one of the verification fundamentals in ISO 14064 3 [2] (International Standard for GHG Emissions Inventories and Verification). Materiality is defined in the International Accounting Standards Board’s (IASB) "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

> *"Information is material if its omission or misstatement could influence the economic decision 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."*

The concept of materiality enables the auditor to place increased attention to elements where even minor errors may result in significant deviations from the true value or desired result.

Upon completion of an assessment (validation or verification), a DOE should declare that the underlying documents (PDD or monitoring report), which form the basis of a request for registration or a request for issuance, are free of material errors. That is, there may still be errors […omissions, misstatements] which may not have been detected in the assessment of the project with reasonable means. However, in total the risk for such errors should be smaller than the materiality threshold and/or should not lead to a different conclusion. This principle does not permit the omission of any relevant fact or data sources or exclude project participants from addressing any found errors but serves as justification of a cut-off for the level or scrutiny in the auditing and consequently also in the reporting.

[1] Wiley GAAP 2008, Epstein, Nach, Bragg, p.10.
[2] http://www.epa.gov/ttn/chief/conference/ei16/session13/wintergreen.pdf

What are the consequences of ignoring materiality?

The materiality threshold should be set by the regulatory body of an auditing scheme, in this case the CDM-EB. Although this concept was included in the draft version of the Validation and Verification Manual (VVM), it was however, unfortunately excluded from the first approved version. The consequence of excluding materiality means that, in theory, the verifiers' risk goes up to infinity, since an error of e.g. 1 ton $CO2_e$ is considered as material as an error of 1000 ton $CO2_e$ with the same consequences for non-detection. Without the application of materiality a DOE should be 100 % sure that no wrong figure or statement is given within the assessed documents no matter what significance such a mistake would have. However, even with the highest level of scrutiny, it is not possible to find every single mistake and this reality needs to be recognised and addressed.

In practice, nothing has changed since the introduction of the UNFCCC VVM [no materiality] compared to the previous IETA VVM [which foresees application of materiality]. DOE's did not apply materiality before the introduction of the UNFCCC VVM because of:

1. a diverging understanding of this principle among DOE themselves and among DOEs and project participants (indicating the need for guidance)
2. the fact that the regulatory environment, in particular liability aspects, discourages the implementation of materiality, even if the VVM would explicitly apply it.

Understanding materiality

Before the introduction of the UNFCCC VVM, DOEs have issued opinions referring to "risk based approach" and "materiality". However, few of the DOE's have been able to explain how these concepts were applied by them, and how this translated into the approach chosen for the project under consideration. It is therefore not surprising that the situation before and after the introduction of the VVM did not change.

In order to implement the concepts of materiality and risk based approach both the EB and the DOEs have to be clear how they want to see the concepts applied. Clarifying this might be best facilitated by a professional audit firm that is familiar with these concepts and applies them in their daily practice. An example of an application of materiality in emissions trading is the EU Emission trading Scheme (ETS) which sets their materiality threshold based on the installation category. This system can perhaps be used as reference in the design of a CDM-unique standard.

Liability counteracts materiality

DOEs are concerned about their liabilities. This is because they are held responsible for any CER which may be inappropriately issued. In such cases, DOEs have to replace a corresponding amount of “valid” CERs for those issued in err. At spot market prices, this could prove to be an expensive penalty. Although this situation has never occurred, it is very much in the mind of DOEs. The new regulation for Programme of Activities has reiterated this potential "buy back" sanction and the EB has therefore shown that it considers this sanction as a serious option.

Liability cannot be seen in isolation from materiality. Sanctioning every CER that is found to be unjustly issued is the same as cancelling materiality -- even if such concepts with appropriate thresholds were to be included in the VVM. Under such conditions, DOEs would limit risk exposure by continuing the current practice of devoting enormous amounts of time checking every documented detail and second guessing minor issues with little or no concern for the issues' ultimate impact on the final result. The CDM loses as this practice makes it less efficient, with increasing transactional costs and, as a result, global emission reduction targets suffer.

In order to implement the concept of materiality, in addition to including the principle in the VVM, the EB must give clarity on how it sees the implementation of the potential sanction that DOEs must buy CERs on the market that were issued due to a faulty verification process.

Furthermore, a large fraction of request for registration or issuance is selected for review. Requests for review do not always focus on issues that can have material influence. In this policy environment it would be irrational for a DOE to apply the concept of materiality, thus increasing the transaction costs for project developers without significant returns in terms of added assurance for the regulator.

Therefore, it is also necessary, after including materiality in the VVM and providing clarity on the "buy back" policy, to apply the concept of materiality across the policy environment, as well.

Summary

The concept of materiality is not foreseen in the UNFCCC VVM, contrary to the previous IETA VVM and the first draft version of the VVM. In practice, even when materiality was explicitly encouraged by the IETA VVM, DOEs did not have sufficient guidance to apply it properly. This is partly because DOEs were not clear about the practical application of the concept and partly because the regulatory environment discouraged application of materiality. The liability issue, in particular the "buy back" sanction, effectively cancels application of materiality.

In addition to including materiality in the VVM, the following actions must also be taken in order to ensure correct application of the principle:

- The definition of materiality should be practicable enough to allow common understanding and application;
- The EB should take a clear position on the "buy back sanction", clarifying that this applies to structural incompetence rather than to non material errors that could come to light after the validation or registration;
- The RIT/Secretariat should apply the principle of materiality on the requests that it handles. This means that the issues on which requests for review are concentrated should be issues material to the overall validation/verification result.