

EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG TEG MEETING

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Exposure Draft *Definition of Material*

Issues Paper - Towards a Draft Comment Letter

Objective

- 1 The objective of this issues paper is to discuss EFRAG TEG's views on the questions expected to be included in the forthcoming Exposure Draft *Definition of Material*.

Basis for the tentative views expressed in this paper

- 2 In preparing the tentative responses, the EFRAG Secretariat considered the tentative views expressed by EFRAG TEG, EFRAG CFSS and the EFRAG User Panel in previous meetings. The views expressed by EFRAG in the following publications were also considered:
 - (a) Discussion Paper *Towards a Disclosure Framework for the Notes* issued by EFRAG, the ANC and the FRC;
 - (b) EFRAG's comment letter in response to the IASB's Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting*;
 - (c) EFRAG's comment letter in response to the IASB's Exposure Draft ED/2015/8 *IFRS Practice Statement: Application of Materiality to Financial Statements* (the 'Materiality Practice Statement'); and
 - (d) EFRAG's comment letter in response to the IASB's Exposure Draft ED/2014/1 *Disclosure Initiative - Proposed amendments to IAS 1*.
- 3 EFRAG TEG's input will be used in preparing the draft comment letter that will be presented at a future meeting.

Section 1 - Expected amendments to the definition of ‘material’

Notes to EFRAG TEG

- 4 The ED is expected to propose the following amendments to the definition of materiality that is contained in paragraph 7 of IAS 1 *Presentation of Financial Statements* and paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*:
- Use the revised wording that was proposed in the Conceptual Framework Exposure Draft (the final Conceptual Framework is expected to be issued later this year) as a starting point, except to refer to financial statements rather than financial reports.
 - Include reference to ‘obscuring information’ in the definition. This change is meant to address the concern raised by some that the existing definition is over focusing on what information cannot be omitted rather than why it is unhelpful to include too much immaterial information. This change incorporates in the definition an existing requirement in paragraph 30A of IAS 1 that states ‘An entity shall not reduce the understandability of its financial statements by **obscuring** material information with immaterial information.’ [emphasis added].
 - Replace the threshold ‘could influence’ with ‘could reasonably be expected to influence’. This wording is meant to address concerns raised by some parties that the threshold ‘could influence’ in the existing definition of material is too broad. This change incorporates in the definition the clarification in paragraph 7 of IAS 1 that states that ‘the assessment needs to take into account how users with such attributes **could reasonably be expected to be influenced** in making economic decisions.’ [emphasis added].
- 5 As a consequence of the proposal, paragraph 7 of IAS 1 and paragraph 5 of IAS 8 would be revised as follows:
- Information is ~~Omissions or misstatements of items are~~ material if omitting, misstating or obscuring it they could **reasonably be expected to, individually or collectively**, influence ~~the economic~~ decisions that the primary users of a specific reporting entity’s general purpose financial statements make on the basis of those ~~the~~ financial statements.
- 6 If any changes are made to IAS 1/IAS 8 as a result of the proposals in the ED, the IASB will make consequential amendments to the definition of materiality that is contained in the Conceptual Framework and in the Materiality Practice Statement.
- 7 The following table provides an overview of the existing and proposed definitions:

Current IAS 1/IAS 8	Conceptual Framework -ED	Expected revised definition in the ED <i>Definition of Material</i>
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.	Information is material if omitting or misstating it could influence decisions that <u>primary users of general purpose financial report</u> make on the basis of financial information about a specific reporting entity.	Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions the primary users of a specific reporting entity’s general purpose financial statements make on the basis of those financial statements

Question 1

Do you agree with this definition of material? Why or why not? If you do not agree, what changes do you suggest, and why?

EFRAG Secretariat's tentative response

Aligning the definition of materiality

- 8 The EFRAG Secretariat welcomes the IASB's initiative to remove inconsistencies in the definition of materiality in IAS 1/IAS 8 and in the Conceptual Framework as the existing differences in language are not meant to reflect different definitions of materiality and the existence of more than one definition of material could be confusing.
- 9 However, the EFRAG Secretariat observes that the definition of materiality is currently repeated in several places (IAS 1, IAS 8, the Conceptual Framework and the Glossary). The IASB could reconsider whether having the definition of materiality repeated in so many places is the most effective way of achieving consistent application. The EFRAG Secretariat considers that the IASB could consider concentrating in a single general standard, such as IAS 1 (in addition to the glossary of terms and the Conceptual Framework). This would also reduce the risk of possible inconsistencies in case of future revisions.
- 10 The EFRAG Secretariat observes that the definition of material in IFRS Standards and in the Conceptual Framework will still differ in one respect as the latter refers to financial reports rather than to financial statements and; as a consequence, the definition of materiality contained in the Conceptual Framework is meant to apply to the whole financial report.
- 11 The EFRAG Secretariat understands that the IASB has not specifically debated the implications of the proposed consequential amendments when deliberating on the Conceptual Framework, especially the potential legal and regulatory effects (for instance how would the concept of obscuring material information apply across the financial report).

Obscuring information

- 12 EFRAG Secretariat welcomes the IASB's proposal to include the concept of obscuring in the definition of material.
- 13 As stated in the EFRAG/ANC/FRC Discussion Paper *Towards a Disclosure Framework for the Notes*, issued in 2012, the focus on materiality has traditionally been to ensure that entities do not omit material information, However, the same attention should be given to ensuring that immaterial information is excluded from the financial statements, as immaterial disclosures may obscure relevant information and thereby hinder understandability.
- 14 The EFRAG Secretariat observes that IFRS Standards do not currently prohibit entities from disclosing immaterial information. The introduction of the term obscuring has the potential to limit the disclosure of immaterial information.
- 15 The EFRAG Secretariat also notes that the reference to the term 'obscuring' is already contained in paragraph 30A of IAS 1 which states that '*an entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions*'.
- 16 However, the EFRAG Secretariat observes that the term 'obscuring' is currently used in the narrow context of paragraphs of IAS 1 discussing aggregation of information.

- 17 Obscuring can be interpreted in different ways (as illustrated in EFRAG Secretariat's response to Question 2 hereafter). In its comment letter in response to the Materiality Practice Statement, EFRAG urged the IASB to consider providing further application guidance on 'obscuring'. This is all the more needed as incorporating the term in the definition of material will extend the application of the concept.
- 18 The IASB should work with preparers, auditors and regulators, as the concept of obscuring needs to be understood and applied by all parties in the financial reporting process and the legal and regulatory aspects need to be carefully considered.
- Could reasonably be expected to influence*
- 19 The EFRAG Secretariat considers that the distinction between 'could' and 'could reasonably be expected to' is largely one of semantics. Because IFRS Standards are a principle-based set of standards, their understanding cannot depend on subtle differences in wording. We do not see that any practical implications should flow from making this distinction. Furthermore, it is questionable whether the distinction will be reflected in translation into other languages.
- 20 The EFRAG Secretariat observes that:
- (a) the reference to 'could reasonably be expected to be influenced' is already used in the guidance accompanying the definition of material in paragraph 7 of IAS 1;
 - (b) In the context of Europe, the definition of materiality in the Accounting Directive already contains a similar threshold ¹and the difference in language has not been identified as a major concern so far; and
 - (c) auditing standards (such as ISA 320 *Materiality in Planning and Performing Audit*) already uses the expression 'could reasonably be expected to influence' when referring to misstatements and omissions
- 21 However, EFRAG Secretariat notes that a different threshold is currently used in paragraph 24 of IAS 1 which states that: 'it would be likely to influence economic decisions made by users'. EFRAG Secretariat recommends that the IASB consider rewording this paragraph as part of the ED. [Note to EFRAG TEG: this comment will be removed if the published ED actually contains an amendment to paragraph 24].

Question to EFRAG TEG

- 22 Does EFRAG TEG agree with the EFRAG Secretariat's tentative responses to the questions expected to be included in the DP? If you do not agree, what changes do you suggest, and why?

¹ Source: Accounting Directive – Article 2 Definitions: *material* means the status of information where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking.

Section 2 - Expected amendments to the accompanying guidance on materiality in IAS 1 and IAS 8

Notes to EFRAG TEG

24 The ED is expected to clarify the explanation contained in paragraph 7 of IAS 1 (and paragraph 6 of IAS 8) that accompanies the definition of material. The proposed changes:

- (d) incorporate the description of the primary users of financial statements based on paragraphs OB5 and QC32 of the Conceptual Framework;
- (e) provide some explanation about the use of the term 'obscuring' in the proposed definition of material; and
- (f) make minor reordering in paragraphs and improvements to their drafting.

25 Consequently, Paragraph 7 of IAS 1 and paragraph 6 of IAS 8 are expected to be revised as follows:

Materiality depends on the size and nature or magnitude of information, or both. An entity assesses whether information is material both individually and in combination with other information in the context of its financial statements. 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. Material information might be obscured if it is not communicated clearly. For example, some users of financial statements might overlook material information if it is surrounded by immaterial information.

Assessing whether information an omission or misstatement could reasonably be expected to influence economic decisions of the primary users of general purpose financial statements, and so be material, requires consideration of the characteristics of those users.

26 Additionally, the following guidance based on paragraphs OB5 and QC32 of the Conceptual Framework is expected to be added to IAS 1 and IAS 8:

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser.

Question 2

Do you agree with the proposed clarifying changes paragraph 7 of IAS 1 and paragraph 6 of IAS 8 that accompanies the definition of material? Why or why not? If you do not agree, what changes do you suggest instead, and why?

EFRAG Secretariat's tentative response

27 The EFRAG Secretariat welcomes the IASB's initiative to improve the wording of the guidance accompanying the definition of material.

28 However, referring generically to 'clear communication', which is not defined in IFRS Standards, is not helpful without being accompanied by further application guidance on the concept of 'obscuring'.

- 29 As mentioned in our responses to Question 1 and 2, the term ‘obscuring’ is not defined in IFRS Standards and there are many ways in which material information can be ‘obscured’, for instance by:
- (a) swamping material information with immaterial one;
 - (b) aggregating material information that have different natures or functions;
 - (c) disaggregating material information that have same nature or function;
 - (d) using unclear language, terminology, or concepts; and
 - (e) placement of the information in other areas of the financial report.
- 30 EFRAG Secretariat observes that determining the appropriate communication depends on many facts and circumstances that are subjective and may be influenced by the user’s perspective.
- 31 EFRAG Secretariat therefore recommends that the Amendments resulting from the ED should better articulate the circumstances in which material information is not obscured by being ‘clearly communicated’. The EFRAG Secretariat observes in that respect that principles of effective communication (including the reference to ‘clear communication’) are already discussed as part of the IASB’s Discussion Paper DP/2017/1 *Principles of Disclosure* issued in March 2017.
- 32 EFRAG Secretariat also observes that other changes in terminology are introduced for which further explanations in the Basis for Conclusions would be useful:
- (a) replacing ‘economic decisions’ with ‘decisions’;
 - (b) replacing ‘size and nature’ with ‘nature and magnitude’; and
 - (c) removing ‘individually or collectively’.
- 33 Furthermore, the EFRAG Secretariat notes that IAS 1 currently uses the terms ‘immaterial’ (paragraphs 29 and 30A) and ‘not material’ (paragraphs 31 and 121). In our opinion, the use of different terms may be interpreted as different measures of materiality. EFRAG therefore recommends that the IASB use one term consistently or, alternatively, clarify that these terms are intended to have the same meaning.
- 34 More broadly, the EFRAG Secretariat notes that significant judgement is required when interpreting other terms used across IFRS Standards that refer to the degree of materiality of facts and circumstances, such as ‘substantial’, ‘significant’, ‘important’, ‘key’ or ‘critical’. In EFRAG’s opinion, the IASB should consider whether the number of terms can be reduced and whether guidance could be provided on how these terms should be interpreted.

Question to EFRAG TEG

- 35 Does EFRAG TEG agree with the EFRAG Secretariat’s tentative responses to the questions expected to be included in the DP? If you do not agree, what changes do you suggest, and why?

Section 3 – Consequential amendments to other pronouncements

Notes to EFRAG TEG

- 37 The IASB expects to issue the Materiality Practice Statement in June 2017 and a revised Conceptual Framework in late 2017. If any changes are made to IFRS Standards as a result of the proposals in this Exposure Draft, the IASB will make consequential amendments to both of these documents.
- 38 The IASB is of the view that the guidance in both the revised Conceptual Framework and the Materiality Practice Statement will not be affected by the proposed amendments in the ED, other than to update the paragraphs that quote the definition of material, which are”
- (a) paragraph 2.11 of the revised Conceptual Framework: containing the definition of Material; and
 - (b) Relevant paragraphs in the Materiality Practice Statement for the wording quoted from paragraph 7 of IAS 1 (and the paragraph 5 of IAS 8).
- 39 The IASB has also identified the following IFRS Standards where the definition of material is quoted or partially quoted that would need to be updated:
- (a) IFRS 2 *Share-based Payment* - Paragraph IG17 (Example 11);
 - (b) IFRS 4 *Insurance Contracts* - Paragraphs IG15 and IG16;
 - (c) IAS 10 *Events after the Reporting Date* - Paragraph 21;
 - (d) IAS 34 *Interim Financial Reporting* - Paragraph 24; and
 - (e) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* - Paragraph 75.
- 40 Lastly, there are many references to ‘economic decisions’ and ‘users of financial statements’ (instead of primary users) in IFRS Standards that do not directly relate to the definition of material. The IASB is of the view that it would not be necessary to change all instances of ‘economic decisions’ to ‘decisions’ and ‘users’ to ‘the primary users of financial statements’ in IFRS Standards

Question 3

Do you have any comments on the proposed consequential amendments to the revised *Conceptual Framework* or the *Materiality Practice Statement*?

EFRAG Secretariat’s tentative response

- 41 The EFRAG Secretariat agrees with the consequential amendments listed in paragraph 39, above.
- 42 The EFRAG Secretariat does not comment, at this stage, on the consequential amendments to the Materiality Practice Statement; as this document is not yet published.
- 43 The EFRAG Secretariat considers that using different terminology has the potential to create confusion. We are concerned that the IASB has not inventoried all instances in current IFRS Standards where the terms ‘economic decisions’ (instead of ‘decisions’) and ‘users’ (instead of ‘primary users’) are used and whether it would be necessary to align the terms in some cases. For example:
- (a) Paragraph IN5 of the Conceptual Framework ED contains a reference to ‘economic decisions’ as it states that *‘the Conceptual Framework contributes to transparency by providing the foundation for Standards that enhance the international comparability and quality of financial information, enabling investors and other market participants to make informed **economic decisions**’* (emphasis added).

- (b) Regarding the use of the term ‘users’ rather than ‘primary users’ in the definition of material, the proposed change is introduced, according to the IASB, to address concerns that the term users may be interpreted too widely and to make the wording clearer. This clarification is likely to benefit other instances where the term is used.

Question to EFRAG TEG

- 44 Do EFRAG TEG agree with the EFRAG Secretariat’s assessment on the consequential amendments of the proposed ED?
- 45 Do EFRAG TEG have any other comments about the expected e proposals in the ED?