EFRAG's Letter to the European Commission regarding endorsement of *Definition of Material (Amendments to IAS 1 and IAS 8)*

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European Commission
1049 Brussels

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Dear Mr Guersent

Endorsement of *Definition of Material (Amendments to IAS 1 and IAS 8)*

Based on the requirements of Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion *on Definition of Material (Amendments to IAS 1 and IAS 8)* ('the Amendments'), which were issued by the IASB on 31 October 2018. An Exposure Draft of the Amendments was issued on 14 September 2017. EFRAG provided its comment letter on that Exposure Draft on 23 January 2018.

The objectives of the Amendments are to clarify the definition of material by including guidance that until now has featured elsewhere in IFRS Standards; align the definition used in the Conceptual Framework with that in the IFRS Standards themselves; and improve the explanations accompanying the definition.

The Amendments shall be applied prospectively for annual periods beginning on or after 1 January 2020 with earlier application permitted. If entities apply the Amendments earlier, they shall disclose that fact. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

Based on the above reasoning, EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raise no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 The IASB was informed at the Discussion Forum on Financial Reporting Disclosure it hosted in January 2013, through feedback on the 2014 amendments to IAS 1, the 2017 Discussion Paper *Disclosure Initiative—Principles of Disclosure*, and from other sources, that entities experienced difficulties in making materiality judgements when preparing financial statements.

2 The Amendments aim at clarifying the definition of material and its application and help entities make better materiality judgements without substantively changing existing requirements.

The issues and how they have been addressed

3 The Amendments address the following concerns highlighted by some stakeholders about the previous definition of material:

(a) the use of the phrase 'could influence' (decisions of users) to describe whether information is material might encourage entities to disclose immaterial information in their financial statements;

(b) the concepts of 'omitting' and 'misstating' information focus only on information that cannot be omitted and the definition of material should also explain why it is unhelpful to include immaterial information;

(c) the definition refers to 'users' but does not specify their characteristics, which may be interpreted by some as implying that an entity is required to consider all possible users when deciding what information to disclose.

4 The Amendments were also drafted to address concerns that the wording in the definition of material was different in the *Conceptual Framework for Financial Reporting*, IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

What has changed?

5 The Amendments address the above concerns by:

(a) replacing the term 'could influence' with 'could reasonably be expected to influence';

(b) including the concept of 'obscuring information' alongside the concepts of 'omitting' and 'misstating' information in the definition of material;

(c) clarifying that the 'users' referred to are the primary users of general purpose financial statements referred to in the Conceptual Framework; and

(d) aligning the definition of material across IFRS publications.

6 The amended definition of material therefore states that 'Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity'.

Interaction with Other Amendments

7 On 29 March 2018, the IASB issued *Amendments to References to the Conceptual Framework in IFRS Standards* (applicable for annual periods beginning on or after

1 January 2020 with early application allowed), which affects some of the paragraphs of IAS 1 and IAS 8 dealing with the definition of material.

8 To allow early adoption of the Amendments independent of the adoption of *Amendments to References to the Conceptual Framework in IFRS Standards*, the IASB has issued a second version of the Amendments, applicable for entities that have not early adopted *Amendments to References to the Conceptual Framework in IFRS Standards,* removing the references to the old Conceptual Framework.

When do the Amendments become effective?

9 The Amendments are effective from 1 January 2020 and are required to be applied prospectively. Early application is permitted.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (the 'IAS Regulation'), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (the 'Accounting Directive'); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise – this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of those Directives'* (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 Lastly EFRAG has assessed that the limited differences in the drafting versions of the Amendments (see Appendix1), introduced to allow early adoption of the Amendments independent of the adoption of *Amendments to References to the Conceptual Framework in IFRS Standards,* would not affect its assessment against the endorsement criteria. Therefore the two versions of the Amendments have been assessed together.

Relevance

7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

8 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether they would result in the omission of relevant information.

9 The definition of material does affect relevance insofar as materiality is an entity-specific aspect of relevance.

10 EFRAG firstly observes that the Amendments are intended to help entities apply better materiality judgements by including some of the existing supporting requirements in IAS 1 into the definition to give them more prominence, without intending to substantively change the definition.

11 The existing requirements (including the concept of 'obscuring' and the threshold 'could reasonably be expected to influence'.) have been previously assessed to lead to relevant information. In its 2015 Endorsement Advice on *Disclosure Initiative – Amendments to IAS 1*, which introduced the notion of 'obscuring' into the explanatory guidance to the definition of 'material', EFRAG assessed in particular that the change would 'enhance an entity's ability to apply judgement in presenting relevant information'. EFRAG considers that the same conclusion holds for the Amendments.

12 Similarly, EFRAG considers that including the threshold 'could reasonably be expected to influence' in the definition helpfully emphasises that materiality decisions require judgement and clarifies the nature of the judgement to be made in assessing when information is material.

13 Combined with the clarification that the users to whom the definition refers are the 'primary users', the changes have the potential to enhance the quality of materiality judgement made by entities.

14 EFRAG's overall assessment is that the Amendments would not result in the omission of relevant information and, therefore, satisfy the relevance criterion.

Reliability

15 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

16 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

17 The Amendments do not directly change the way transactions are accounted for or presented. However, the application of materiality can affect reliability in many aspects in particular as regards completeness and freedom from 'material' error.

18 EFRAG understands that the IASB's objective in introducing the concept of 'obscuring' into the definition of material is to improve the communication of material information by discouraging entities from obscuring it within immaterial information. EFRAG does not consider that this change would affect entities' judgements as to whether a particular item of information is or is not itself material.

19 EFRAG's overall assessment is that the Amendments would result in the provision of reliable information and therefore satisfy the reliability criterion.

Comparability

20 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

21 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

22 Although the Amendments do not directly affect the way transactions are accounted for, comparability may be enhanced by a more consistent application of the concept of material because:

(a) aligning the definition of material and concentrating the guidance in a single general standard, have the potential to make the definition easier to understand and therefore more consistently applied; and

(b) replacing the threshold 'could influence' with 'could reasonably be expected to influence' helpfully emphasises that materiality decisions require judgement and clarifies the nature of the judgement to be made in assessing when information is material.

23 EFRAG acknowledges that the concept of 'obscuring' introduced in the definition is inherently more judgemental than 'omitting' or 'misstating' information. However EFRAG observes that the concept is not new as it was already contained in the explanatory paragraphs to the definition of material in IAS 1.

24 In its comment letter in response to the preceding IASB Exposure Draft, EFRAG suggested that the definition could be further clarified and made more direct by removing the references to 'omitting, misstating or obscuring' and addressing those concepts in separate guidance.

25 Although the issued Amendments do not incorporate the above suggestion, EFRAG observes that they do include further guidance on the concept of 'obscuring' in the explanatory paragraphs to the definition of material and examples of circumstances in which material information might be obscured. Based on that, EFRAG assesses that the level of judgement in applying the concept is not such that it would result in information that is not comparable.

26 Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

27 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

28 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

29 As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

30 First, EFRAG observes that the Amendments do not introduce new concepts or requirements that would create complexity and impair understandability. Instead, as mentioned above, the Amendments merely include some of the supporting requirements already existing in IAS 1 in the definition to give them more prominence.

31 EFRAG also agrees that the understandability of information (by users) is enhanced when relevant information is not obscured by irrelevant one. In this regard, EFRAG observes that existing paragraph 30A of IAS 1 already 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'.

32 In EFRAG's view, the Amendments do not introduce any new complexity, therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

33 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

34 As mentioned above, the Amendments do not substantially change the existing requirements and do not affect recognition and measurement. EFRAG has therefore concluded that they raise no issues in relation to prudence as defined above.

True and fair view principle

35 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of an entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

36 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards. On the contrary, aligning the definition of material across IFRS Standards, the Conceptual Framework and other publications reduces complexity and has the potential to ensure more consistency in application.

37 Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

38 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

39 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments essentially incorporate existing guidance from the Conceptual Framework and IAS 1 and are not substantive changes to the existing requirements in IFRS Standards.

4 EFRAG assesses that the revised definition of material can help entities make better materiality judgements and therefore improve the quality of financial reporting. This is because, although the Amendments essentially incorporate existing guidance from the Conceptual Framework and IAS 1 and are not substantive changes to the existing requirements in IFRS Standards, they are expected to improve the understanding of the definition and the application of the concept of material by:

(a) aligning the wording in different pieces of literature so as to avoid the potential for confusion arising from different definitions;

(b) incorporating supporting requirements in IAS 1 into the definition to give them more prominence and clarify their applicability through accompanying guidance and examples; and

(c) grouping the existing guidance on the definition of material in one place, together with the definition.

5 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's ~~initial~~ analysis of the costs and benefits of the Amendments

6 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

7 Therefore, as explained more fully in the main sections of this Appendix, the approach that EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendments in the EU, to consult on the results of those initial assessments, and to finalise those assessments in light of the comments received.

Cost for preparers

8 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

9 EFRAG's ~~initial~~ assessment is that the Amendments will not result in significant one-off costs and will be cost-neutral on an ongoing basis for preparers. Any one-off costs are expected to be limited to familiarisation with the Amendments and updating any internal guidance. This is because the Amendments:

(a) do not change existing recognition or measurement requirements;

(b) are based on existing guidance and do not introduce substantive changes to the definition of material; and

(c) are applicable prospectively and therefore entities are not required to revisit previously made assessments.

Costs for users

10 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

11 EFRAG's assessment is that the implementation of the Amendments will not result in increased costs to users; that is, they are likely to be cost neutral.

Benefits for preparers and users

12 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

13 Overall, EFRAG's assessment is that:

(a) users are likely to benefit from the Amendments as they have the potential to reduce instances in which material information may be obscured by immaterial information and therefore to enhance users' analysis;

(b) preparers are likely to benefit from the Amendments as the revised guidance has the potential to help entities make better materiality judgements.

Conclusion on the costs and benefits of the Amendments

14 EFRAG's overall assessment is that the overall benefits of clarifying the definition of material and its application and helping entities make better materiality judgements are likely to outweigh costs associated with the implementation of the Amendments.

Conclusion

15 EFRAG considers that the Amendments will bring improved financial reporting when compared to previous guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

16 EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

17 Furthermore, EFRAG has not identified any other factors that would mean endorsement of the Amendments is not conducive to the European public good.

18 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.