EFRAG's Draft Letter to the European Commission Regarding Endorsement of *Disclosure of Accounting Policies (Amendments to IAS 1 and IFRS Practice Statement 2)*

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European Commission
1049 Brussels

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Dear Mr John Berrigan

Endorsement of *Disclosure of Accounting Policies (Amendments to IAS 1 and IFRS Practice Statement 2)*

Based on the requirements of the 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 the *Disclosure of Accounting Policies (Amendments to IAS 1 and IFRS Practice Statement 2*) ('the Amendments') which were issued by the IASB on 12 February 2021. An Exposure Draft of the Amendments was issued on 1 August 2019. EFRAG provided its comment letter on that Exposure Draft on 12 December 2019.

The objective of the Amendments is to develop guidance and examples to help entities apply materiality judgements to accounting policy disclosures. More specifically, the Amendments require entities to disclose their material accounting policy information rather than their significant accounting policies. To support this amendment the Board also amended IFRS Practice Statement 2 *Making Materiality Judgements (Materiality Practice Statement)* to explain and demonstrate the application of the 'four-step materiality process' to accounting policy disclosures.

The Amendments shall be applied prospectively for annual periods beginning on or after 1 January 2023 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.

As noted above, the Amendments introduce changes to both IAS 1 *Presentation of Financial Statements* and to the IFRS Practice Statement 2 *Making Materiality Judgement*. The present endorsement advice only addresses the changes to IAS 1 as the Practice Statement has not been endorsed for application in the European Union.

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 feedback on the IASB's Discussion paper on Principles of Disclosure, issued in 2017, suggested that guidance was required to assist entities in determining which accounting policies to disclose.

The issues and how they have been addressed

2 Respondents noted that the application of materiality was key to deciding which accounting policies to disclose, however IAS 1 Presentation of Financial Statements did not refer to materiality but states that '[a]n entity shall disclose its significant accounting policies' without providing a definition for the term 'significant'.

3 In July 2018, the IASB added a project to its agenda to develop guidance and examples to help entities apply materiality judgements to accounting policy disclosure.

4 The final Amendments were issued on 12 February 2021.

What has changed?

5 The Amendments revise 117–122 of IAS 1 to require entities to disclose their material accounting policy information rather than their significant accounting policies. To support this amendment the IASB also amended IFRS Practice Statement 2 *Making Materiality Judgements* to explain and demonstrate the application of the 'four-step materiality process' to accounting policy disclosures.

6 The Amendments also state that information about accounting policy is material if, when considered together with other information included in an entity's financial statements, it can reasonably be expected to influence the decisions that the primary users of those financial statements make.

7 The Amendments provide examples of circumstances in which entities would normally conclude that information about an accounting policy is material to its financial statements. These examples might also help entities determine whether accounting policy information is material.

8 The Amendments also clarify that:

(a) not all information about accounting relating to material transactions, other events or conditions is itself material;

(b) accounting policy information is material if users of an entity's financial statements would need it to understand other material information in the financial statements;

(c) disclosing immaterial information about accounting policy is not prohibited but that it shall not obscure material accounting policy information; and

(d) the Amendments do not relieve an entity from meeting other disclosure requirements within IFRS Standards.

When do the Amendments become effective?

9 An entity shall apply the Amendments to IAS 1 for annual periods beginning on or after 1 January 2023. Early application is permitted. If an entity applies the Amendments for an earlier period, it shall disclose that fact.

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

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606 2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments leads to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS Standards in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS Standard or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS Standards or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

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

10 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.

11 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.

12 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).

13 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.

14 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.

15 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether it meets all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS Standards and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 16 to 20;

(b) reliability: paragraphs 21 to 25;

(c) comparability: paragraphs 26 to 27

(d) understandability: paragraphs 31 to 36;

(e) whether overall they lead to prudent accounting: paragraphs 37 to 38; and

(f) whether they would not be contrary to the true and fair view principle: paragraphs 39 to 42.

Relevance

16 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.

17 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.

18 EFRAG observes that the Amendments are intended to develop guidance and examples to help entities apply materiality judgements to accounting policy disclosure in order to identify and disclose accounting policy information that is material to users of financial statements and remove immaterial accounting policy information that may obscure material accounting policy information.

19 EFRAG notes that 'Materiality' is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an entity's financial statements. EFRAG therefore considers that the anchorage of the guidance to the concept of materiality better enable preparers to apply judgment to disclose information that is relevant to the primary users about accounting policies.

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

Reliability

21 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.

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

23 The Amendments do not directly change the way transactions are accounted for or presented. However, the disclosure of accounting policy information provides context for the other information contained in the financial statements and affects reliability in aspects such as the completeness and faithful representation of the overall information.

24 EFRAG considers that the amendments have the potential to result in information that more faithfully depict how an entity has exercised judgement in selecting and applying the accounting policies in its specific circumstances.

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

Comparability

26 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.

27 The Amendments do not directly affect recognition and measurement and therefore the way transactions or events are accounted for.

28 The Amendments clarify that Accounting policy information that focuses on how an entity has applied the requirements of the Standards to its own circumstances provides entity-specific information that is more useful to users of financial statements than standardised descriptions, or information that only duplicates or summarises the requirements of the Standards.

29 EFRAG considers that comparability does not mean uniformity and less uniformity in disclosures between entities does not necessarily lead to a loss of comparability if entities apply judgement appropriately in the provision of information that is relevant, based on the specific nature of their operations.

30 EFRAG has therefore concluded that they raise no issues in relation to comparability as defined above.

Understandability

31 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.

32 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.

33 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.

34 EFRAG observes that the Amendments do not introduce new concepts or requirements that would create complexity and impair understandability. Instead, the Amendments extend the application of the existing principle of materiality to information about accounting policies

35 EFRAG considers that replacing the undefined concept of 'significance' with the defined concept of 'materiality' fosters the understandability of the information by

users as it better relates the assessment on accounting policies with the broader application of materiality to the other information contained in the financial statements.

36 Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

37 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.

38 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

39 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.

40 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards. On the contrary, adjusting the disclosures requirements about accounting policy information to use concepts already defined in the IFRS Standards reduces complexity and has the potential to ensure more consistency in application.

41 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.

42 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

43 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

44 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.

45 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

46 EFRAG considers that replacing the existing reference to 'significance' (which is not defined in IFRS Standards) with the defined concept of 'materiality', together with the accompanying guidance and examples, has the potential to help entities better exercise their judgements to identify disclosure accounting policies information that are material to users.

47 The Amendments will also foster the overall understandability of the information by better relating as the assessment on accounting policies with the broader application of materiality to the other information contained in the financial statements.

48 The reference to materiality is also likely to put more focus on entity-specific information that describes how an entity has applied the requirements of a Standard to its own circumstances. EFRAG considers that such entity-specific disclosures are more useful to users of financial statements than standardised descriptions, or information that only duplicates or summarises the recognition or measurement requirements of the Standards.

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

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

50 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, as they are narrow in scope, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

51 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

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

53 EFRAG's assessment is that the Amendments may have an initial cost for preparers to familiarise with the application of the concept of materiality to their accounting policy disclosures and updating any internal guidance. Preparers may also have ongoing costs as they need to apply their own judgment on a recurrent basis to determine what accounting policy information is material. However, we do not expect these costs to be significant as the Amendments:

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

(b) do not require entities to change its internal systems significantly; and

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

54 Overall, EFRAG's assessment is that Amendments are likely to result in insignificant initial and ongoing costs for preparers related to implementation.

Costs for users

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

56 Except for getting familiar with the revised material accounting policy information, users are not expected to incur implementation cost insofar as the Amendments are applied prospectively and users will not be required to update their data for past periods and re-establish comparable information about trends.

57 Overall, 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

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

59 Users are likely to benefit from:

(a) more entity-specific disclosures that explain how an entity has applied the requirements of the IFRSs to its own circumstances;

(b) less immaterial accounting policy information that may obscure material accounting policy information; and

(c) greater understandability of the information as the assessment on accounting policies will better relate with the broader application of materiality to the other information contained in the financial statements

60 Preparers are likely to benefit from the revised guidance that has the potential to help them better exercise their judgements. In some circumstances, the amendments may reduce the cost of preparing financial statements by eliminating or reducing the disclosure of immaterial information about accounting policy information.

61 Overall, EFRAG's assessment is that both preparers and users are likely to benefit from the Amendments as they will help entities identify and disclose accounting policy information that is material to users.

Conclusion on the costs and benefits of the Amendments

62 EFRAG's overall assessment is that the overall benefits of implementing the Amendments are likely to outweigh its costs.

Conclusion

63 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.

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

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

66 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.