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Endorsement of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

Introduction, background and conclusions

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by EFRAG

1. INTRODUCTION

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union. The Commission Services together with European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as an analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an Effect Study for interpretation IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* (attached). As the EFRAG Effect Study refers to the Endorsement Advice, we also included it in attachments. In the light of the size and extent of the issue, the Commission Services asked EFRAG to prepare a small report.

This cover note contains introduction, comments and a conclusion by the Commission Services.

2. BACKGROUND ON IFRIC 19

Entities assume and settle financial liabilities as a normal function of financing activities. Financial liabilities are settled in accordance with terms and conditions set at its inception, normally in cash. However, in times of financial difficulty an entity may not be able to settle its financial liabilities in accordance with the original terms of the liability. In such instances, entities often renegotiate the terms to allow settlement through the issue of their own equity instruments.

In practice there is a need for clarification on how a debtor should account for its equity instruments issued in full or partial settlement of a financial liability following renegotiation of the terms of the liability sometimes referred to as a 'debt-for-equity swap'. The existing literature is not clear in this respect.

How does IFRIC 19 suggest dealing with the issue?

IFRIC 19 clarifies that such equity instruments issued is 'consideration paid' as intended in paragraph 41 of IAS 39 *Financial Instruments: Recognition and Measurement*. Furthermore, such a transaction shall be measured at the fair value of the equity instruments issued unless this value cannot be reliably determined, in which case the fair value of the liability extinguished shall be used. IFRIC 19 also provides guidance on partial extinguishment and the presentation of any gains and losses resulting from a debt-for-equity swap.

IFRIC 19 becomes effective for annual periods beginning on or after 1 July 2010, with earlier application permitted.

EFRAG consultations

EFRAG published its initial assessment and supporting analysis on 14 December 2009. EFRAG received five comment letters. Two respondents agreed with EFRAG's assessment of the benefits of implementing IFRIC 19 and the associated costs involved for users and preparers. The other three respondents did not comment specifically on EFRAG's initial assessment of the costs and benefits of implementing IFRIC 19 in the EU, but supported EFRAG's recommendation that IFRIC 19 be adopted for use in Europe.

3. EFFECT ANALYSIS AND CONCLUSIONS

Main points identified in the EFRAG Effect Analysis

EFRAG supports IFRIC 19 and has concluded that it meets the requirements of Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC and that it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

<p>The Commission Services agree with the EFRAG analysis and conclude that IFRIC 19 will contribute to a more consistent application of the standard and provide the necessary clarification needed. In that respect it meets all the qualitative criteria.</p>

Costs and benefits for preparers and users

Costs for preparers

In summary, EFRAG's assessment is that IFRIC 19 will result in some incremental year one costs for some preparers and little or no ongoing costs.

The Commission Services agree that IFRIC 19 will not involve preparers in incremental year one costs, except for those who have to change their existing practice, although it can be expected that those year one costs are likely to be insignificant.

Costs for users

EFRAG is not aware of any aspect of IFRIC 19 that is likely to increase the costs users will incur in analysing the financial statements as a result of its adoption.

Benefit for preparers and users

IFRIC 19 provides clarification regarding the application of existing IFRS and will therefore enhance the comparability of the information provided. IFRIC 19 is expected to result in a reduction in the diversity of current practice.

Conclusion

EFRAG’s assessment is that the benefits to be derived from adopting IFRIC 19 are likely to outweigh the costs involved.

Based on the EFRAG analysis the Commission Services summarise that it is expected that IFRIC 19 will:

- (a) involve some additional year one and little or no ongoing costs for some preparers, although expected to be insignificant;
- (b) involve no year one or ongoing incremental costs for users; and
- (c) result in an improvement in the comparability, and therefore the quality, of the information provided and thus bring benefits to users.

4. OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS

On the basis of EFRAG's Effect Study, the Commission Services have considered the main costs and benefits of endorsing IFRIC 19. The Services conclude that the benefits of endorsing IFRIC 19 outweigh the costs introduced.

The Commission services believe that IFRIC 19 will have positive cost-benefit effects and that it should therefore be endorsed in the EU without delay.



The costs and benefits of implementing IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*

Introduction

- 1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*.
- 2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of IFRIC 19, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this.) Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing IFRIC 19 in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

- 3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A summary of IFRIC 19

- 4 Entities assume and settle financial liabilities as a normal function of financing activities. Financial liabilities are settled in accordance with terms and conditions set at its inception, normally in cash. However, in times of financial difficulty an entity may not be able to settle its financial liabilities in accordance with the original terms of the liability. In such instances, entities often renegotiate the terms to allow settlement through the issue of their own equity instruments.
- 5 IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* provides guidance on how a debtor should account for its equity instruments issued in full or partial settlement of a financial liability following renegotiation of the terms of the liability, sometimes referred to as a 'debt-for-equity swap'.
- 6 IFRIC 19 concludes that equity instruments issued to extinguish a financial liability should be treated as 'consideration paid' and shall be measured at their fair value as determined on the date when the financial liability is extinguished. However, IFRIC 19 acknowledges that in some cases entities might be unable to measure equity instruments reliably. In that case, IFRIC 19 states that the fair value of the financial liability extinguished will serve as a proxy.
- 7 IFRIC 19 further clarifies that if only part of the financial liability is extinguished, the entity shall assess whether some of the consideration paid relates to a modification of the part of the liability that remains with the entity. If that is the case, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding. The entity shall consider all relevant facts and circumstances in making this allocation.
- 8 A gain or loss resulting from a debt-for-equity swap shall be recognised in profit or loss and presented as a separate line item in the statement of comprehensive income.

EFRAG's initial analysis of the costs and benefits of IFRIC 19

- 9 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing IFRIC 19, both in year one and in subsequent years. The results of EFRAG's initial assessment can be summarised as follows. The implementation in the EU of IFRIC 19 is likely to:
 - (d) involve some additional year one and little or no ongoing costs for some preparers. EFRAG's initial assessment is that, when considered in aggregate, those costs will not be significant;
 - (e) involve no year one or ongoing incremental costs for users; and
 - (f) result in an improvement in the comparability, and therefore the quality, of the information provided and thus bring benefits to users.
- 10 EFRAG published its initial assessment and supporting analysis on 14 December 2009. It invited comments on the material by 20 January 2010. In response, EFRAG received five comment letters. Two respondents agreed with EFRAG's assessment of the benefits of implementing IFRIC 19 and the associated costs involved for users and preparers. The other three respondents did not comment specifically on EFRAG's initial assessment of the costs and benefits of implementing IFRIC 19 in the EU, but supported EFRAG's recommendation that IFRIC 19 be adopted for use in Europe.

EFRAG's final analysis of the costs and benefits of IFRIC 19

- 11 Based on its initial analysis and stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of IFRIC 19 is presented in the paragraphs below.

Costs for preparers

- 12 EFRAG's assessment is that IFRIC 19 will not involve preparers in incremental year one costs, except for those who have to change their existing practice. These preparers will incur what EFRAG understands to be insignificant year one costs to amend their procedures and apply the amendment retrospectively.
- 13 In addition, preparers would have had to measure these transactions at fair value and the Interpretation only clarifies which instrument's fair value should be used. To this extent preparers are unlikely to incur any significant incremental year one or ongoing costs.
- 14 In summary, EFRAG's assessment is that IFRIC 19 will result in some incremental year one costs for some preparers and little or no ongoing costs.

Costs for users

- 15 EFRAG is not aware of any aspect of IFRIC 19 that is likely to increase the costs users will incur in analysing the financial statements as a result of its adoption.

Benefit for preparers and users

- 16 In EFRAG's view, IFRIC 19 will enhance the comparability of the information provided by eliminating some of the uncertainty that currently exists about the application of existing IFRS. It is expected that this will result in a reduction in the diversity of current practice.

Conclusion

- 17 Summarising the comments above, EFRAG's assessment is that IFRIC 19 is likely to:
- (a) involve some additional year one and little or no ongoing costs for some preparers. EFRAG's assessment is that, when considered in aggregate, those costs will not be significant;
 - (b) involve no year one or ongoing incremental costs for users; and
 - (c) result in an improvement in the comparability, and therefore the quality, of the information provided and thus bring benefits to users.
- 18 EFRAG's assessment is that the benefits to be derived from adopting IFRIC 19 are likely to outweigh the costs involved.

Stig Enevoldsen
EFRAG, Chairman
29 January 2010

Attachment 2



Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

29 January 2010

Dear Mr. Holmquist

Adoption of IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*

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 we are pleased to provide our opinion on the adoption of IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments* (IFRIC 19), which was issued by the IFRIC on 26 November 2009. It was issued as an Draft Interpretation in August 2009 and EFRAG commented on that draft.

IFRIC 19 provides guidance on how a debtor should account for its equity instruments issued in full or partial settlement of a financial liability following renegotiation of the terms of the liability sometimes referred to as a 'debt-for-equity swap'. In particular, it clarifies that such equity instruments issued is 'consideration paid' as intended in paragraph 41 of IAS 39 *Financial Instruments: Recognition and Measurement*. Furthermore, such a transaction shall be measured at the fair value of the equity instruments issued unless this value cannot be reliably determined, in which case the fair value of the liability extinguished shall be used. IFRIC 19 also provides guidance on partial extinguishment and the presentation of any gains and losses resulting from a debt-for-equity swap.

IFRIC 19 becomes effective for annual periods beginning on or after 1 July 2010, with earlier application permitted.

EFRAG has carried out an evaluation of IFRIC 19. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it 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.

EFRAG supports IFRIC 19 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the “true and fair principle” set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRIC 19 and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

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

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

APPENDIX BASIS FOR CONCLUSION

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRIC Interpretation 19 Extinguishing Financial Liabilities with Equity Instruments (IFRIC 19).

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, 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 IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

19 When evaluating IFRIC 19, EFRAG asked itself four questions:

- (a) Is there an issue that needs to be addressed?
- (b) If there is an issue that needs to be addressed, is an Interpretation an appropriate way of addressing it?
- (c) Is IFRIC 19 a correct interpretation of existing IFRS?
- (d) Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?

IS THERE AN ISSUE THAT NEEDS TO BE ADDRESSED?

20 EFRAG understands that at present there is diversity in practice as to how entities account for instances where the terms of settlement of a financial liability are renegotiated to allow its settlement through the issue of an entity's own equity instruments. EFRAG agrees that this diversity is undesirable and is an issue that needs to be addressed.

IS AN INTERPRETATION AN APPROPRIATE WAY OF ADDRESSING IT?

21 An Interpretation is an appropriate way of addressing diversity in accounting practice if that diversity arises because of factors other than inconsistencies between IFRS. Furthermore, in EFRAG's view, Interpretations should not be used to address major issues.

- 22 EFRAG's assessment is that the diversity in practice that is the subject of IFRIC 19 falls into neither of these categories. As such, EFRAG has concluded that an Interpretation is an appropriate way of addressing the uncertainties relating to how an entity should account for debt-for-equity swaps.

Is IFRIC 19 a correct interpretation of existing IFRS?

- 23 EFRAG has considered whether IFRIC 19 is a correct interpretation of existing IFRS literature. IFRIC 19 addresses three main issues relating to how a debtor should account for its equity instruments issued either as full or partial settlement of a financial liability following renegotiation of the terms of the liability (a debt-for-equity swap):
- (a) whether an entity's equity instruments issued in a debt-for-equity swap is 'consideration paid' in accordance with paragraph 41 of IAS 39 *Financial Instruments: Recognition and Measurement*;
 - (b) how an entity should measure the equity instruments issued in a debt-for-equity swap; and
 - (c) how an entity should account for any difference between the carrying amount of the financial liability extinguished and the amount of the 'consideration paid'?
- Each of these issues is discussed below.

Are equity instruments issued 'consideration paid' in accordance with IAS 39?

- 24 IAS 39, in paragraph 41, requires that the difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss. However, IAS 39 does not explicitly refer to equity instruments as a possible means of 'consideration paid'.
- 25 At the same time IFRS 2 *Share-based Payments* and IFRS 3 *Business Combinations* make it clear that equity instruments are used as 'consideration paid' to acquire goods and services as well as to obtain control of businesses.
- 26 The Interpretation clarifies that the issuance of equity instruments to settle a financial liability is 'consideration paid' in accordance with paragraph 41 of IAS 39. EFRAG agrees with this conclusion.

How should an entity measure the equity instruments issued in a debt-for-equity swap?

- 27 The IFRIC notes that IFRS literature does not contain general principles for the initial recognition and measurement of equity instruments, but guidance on specific transactions exist including:
- (a) *Initial recognition of compound instruments* (IAS32) – the equity component is the residual after deducting the fair value of the financial liability component from the fair value of the entire instrument;
 - (b) *Cost of equity transactions and own equity instruments acquired and reissued or cancelled* (IAS 32) – no gains or losses are recognised on such transactions;

- (c) *Equity instruments issued in share-based payment transactions* (IFRS 2) – equity is measured at the fair value of the goods or services received, unless that fair value cannot be reliably estimated. Where the fair value of the goods and services received is lower than the fair value of the equity instruments issued an entity shall consider whether unidentifiable goods and services were received; and
 - (d) *Consideration transferred in a business combination* (IFRS 3) – the total consideration transferred is measured at fair value including the acquisition-date fair values of any equity interests issued by the acquirer.
- 9 The IFRIC noted that measurement of the debt-for-equity swap at the fair value of equity instruments issued is in line with the consensus that the issue of an entity's equity instruments is consideration paid in accordance with paragraph 41 of IAS 39. Furthermore, the IFRIC considered that the fair value of the equity instruments issued best reflects the total amount of consideration paid in the transaction, which may include a premium that the creditor requires to renegotiate the terms of the financial liability. At the same time, the IFRIC acknowledged that practical difficulties might arise in measuring the fair value of equity instruments issued, especially in times of financial difficulties.
- 10 Taking into account the above, the IFRIC reached a consensus that the equity instruments issued in a debt-for-equity swap should be measured at their fair value. However, if the fair value of the equity instruments cannot be reliably measured, the equity instruments issued are measured at the fair value of the financial liability extinguished.
- 11 EFRAG agrees that this is an appropriate interpretation of existing IFRS.

How should an entity account for any gain or loss resulting from the debt-for-equity swap?

- 12 Paragraph 41 of IAS 39 states that the entity should recognise a gain or loss in profit or loss for any difference between the carrying amount of the financial liability extinguished and the consideration paid. This is consistent with the Framework's discussion of income:
- (a) Income is increases in economic benefits during the accounting period in the form of...decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants (paragraph 70(a));
 - (b) Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits (paragraph 75); and
 - (c) Income may result from the settlement of liabilities (paragraph 77).
- 13 IFRIC 19 stipulates that a gain or loss resulting from a debt-for-equity swap shall be accounted for in profit or loss and presented as a separate line item in the statement of comprehensive income.
- 14 IFRIC 19 also requires that if a financial liability is only partially extinguished and the 'consideration paid' is for both the extinguishment of part of a financial liability and the modification of the terms of the part of the liability that remains outstanding, the entity shall allocate the 'consideration paid' accordingly. The entity has to consider this

allocation in determining the profit or loss to be recognised on the part of the liability extinguished.

- 15 EFRAG agrees with these conclusions.

DOES THE ACCOUNTING THAT RESULTS FROM THE APPLICATION OF IFRIC 19 MEET THE CRITERIA FOR EU ENDORSEMENT?

- 16 Having concluded that IFRIC 19 is an appropriate interpretation of existing IFRS, EFRAG asked itself whether it believed that the information resulting from the application of IFRIC 19 would meet the criteria for EU endorsement; in other words, that:

- (a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- (b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the Interpretation.

Relevance

- 17 According to the Framework, information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether IFRIC 19 would result in the provision of relevant information – i.e. information that has predictive value, confirmatory value or both.
- 18 EFRAG is not aware of any reason to believe that some or all of the information that results from the application of IFRIC 19 is not relevant, or that IFRIC 19 results in relevant information being omitted. In EFRAG's view, IFRIC 19 merely seeks to achieve consistency in application of existing requirements that have been judged to meet the relevance criteria.

Reliability

- 19 EFRAG considered the reliability of the information that will be provided by applying IFRIC 19. The Framework explains that 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 purports to represent or could reasonably be expected to represent.
- 20 EFRAG notes that the IFRIC acknowledged that reliability concerns might arise in fair value measurement involved in accounting for debt-for-equity swaps because these transactions occur in instances of financial distress. Under such conditions it may be difficult to determine the fair value of the equity instruments issued to extinguish the financial liability. To address such reliability concerns, IFRIC 19 requires that if the fair value of equity instruments issued cannot be estimated reliably, the fair value of the financial liability extinguished shall be used to measure the instruments issued. EFRAG considers that this is an appropriate way to deal with such reliability concerns.

- 21 EFRAG is therefore of the opinion that the information resulting from this interpretation will meet the reliability criterion.

Comparability

- 22 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.
- 23 The IFRIC's objective in issuing IFRIC 19 was to eliminate the current diversity in practice in the accounting for debt-for-equity swaps. In EFRAG's view, IFRIC 19 achieves this objective and will provide information that is more comparable than hitherto.
- 24 Moreover, the transitional provisions of IFRIC 19 require retrospective application of the Interpretation. EFRAG is supportive of such transitional provisions because they maintain the comparability of the information provided over time.

Understandability

- 25 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, as well as accounting, and the willingness to study the information with reasonable diligence.
- 26 'Understandability' is achieved by satisfying other qualitative characteristics. Accordingly, EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of IFRIC 19 is understandable is whether that information will be unduly complex. In EFRAG's view, IFRIC 19 does not introduce any new complexities.

True and Fair

- 27 For the reasons set out above, EFRAG see no reason to conclude that IFRIC 19 is inconsistent with the true and fair view requirement.

Cost and Benefit

- 28 EFRAG has considered whether the benefits of implementing IFRIC 19 in the EU exceed the cost of doing so. EFRAG's assessment is that the benefits of implementing IFRIC 19 outweigh the costs involved.

Conclusion

- 29 After considering all the above arguments, EFRAG has concluded that, on balance, IFRIC 19 satisfies the criteria for EU endorsement and that it is likely to be in the European interest to adopt IFRIC 19. Accordingly, EFRAG recommends its endorsement in Europe.

