EFRAG's Draft Letter to the European Commission Regarding Endorsement of Recognition of Deferred Tax Assets for Unrealised Losses: Amendments to IAS 12

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[dd May] 2016

Dear Mr Guersent

Adoption of Recognition of Deferred Tax Assets for Unrealised Losses: Amendments to IAS 12

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 the *Recognition of Deferred Tax Assets for Unrealised Losses: Amendments to IAS 12* ('the Amendments'), which were issued by the IASB on 19 January 2016. An Exposure Draft of the Amendments was issued on 20 August 2014. EFRAG provided its comment letter on that Exposure Draft on 8 January 2015.

The objective of the Amendments is to clarify the requirements on recognition of deferred tax assets for unrealised losses in order to address diversity in practice in the application of IAS 12 *Income Taxes*. The Amendments become effective for annual periods beginning on or after 1 January 2017 with earlier application permitted. A summary of the proposals 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, i.e. whether the Amendments would provide relevant, reliable, comparable and understandable information, lead to prudent accounting and not be 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.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has assessed the Amendments and has not identified any technical issues. EFRAG considers that they bring appropriate clarifications of the existing principles in IAS 12 for recognition of deferred tax assets in specific cases and will remove existing diversity in practice.

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 lead to prudent accounting. EFRAG has also assessed that the amendments do not create any distortion in interaction with other IFRS and that appropriate disclosure requirements apply. 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.

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 adopting the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3.

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, lead to 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,

Roger Marshall
Acting President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 The IFRS Interpretations Committee was asked to provide guidance that would address the lack of clarity and diversity in practice on how an entity should determine, in accordance with IAS 12 *Income Taxes*, whether to recognise a deferred tax asset for unrealised losses on debt instruments measured at fair value.

2 The IFRS Interpretations Committee reported to the IASB that practice differed because of divergent views in several areas. Consequently, the IASB addressed the issue and issued *Recognition of Deferred Tax Assets for Unrealised Losses: Amendments to IAS 12* ('the Amendments').

The issues and how they have been addressed

3 The specific issues where diversity in practice existed were:

(a) the existence of a deductible temporary difference upon a decrease in fair value;

(b) recovering an asset for more than its carrying amount;

(c) probable future taxable profit; and

(d) combined versus separate assessment.

Existence of a deductible temporary difference upon a decrease in fair value

4 The Amendments have added an example illustrating the application of paragraph 26(d) of IAS 12. The example explains that the difference between the carrying amount of a debt instrument measured at fair value and its tax base gives rise to a deductible temporary difference, when the debt instrument's fair value is lower than its tax base. This is irrespective of whether an entity expects to recover the carrying amount of the debt instrument by holding the asset and collecting contractual cash flows, or by sale.

Recovering an asset for more than its carrying amount

5 The Amendments clarify that the estimate of probable future taxable profit may include the recovery of some of an entity's assets for more than their carrying amount if there is sufficient evidence that it is probable that this will occur. This may be the case, for example, when an entity expects to hold a fixed-rate debt instrument and collect the contractual cash flows.

Probable future taxable profit

6 The Amendments specify that, when evaluating whether an entity will have sufficient taxable profit in future periods, the tax deductions which will arise when those deductible temporary differences reverse are excluded from future taxable profit. As a result, such taxable profit is different from the taxable profit on which income taxes are payable, as defined in paragraph 5 of IAS 12.

Combined versus separate assessment

7 The Amendments require that an entity has to consider whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of the deductible temporary difference. If tax law imposes no such restrictions, an entity

assesses a deductible temporary difference in combination with all of its other deductible temporary differences. However, if the tax law restricts the deductions to a specific type of income (e.g. capital losses can only be offset against capital gains) the assessment combines only deductible temporary differences of the appropriate type.

When do the Amendments become effective?

8 An entity shall apply the Amendments for annual periods beginning on or after 1 January 2017. Earlier application is permitted. An entity shall apply those Amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, on initial application, the change in the opening equity of the earliest comparative period may be recognised in opening retained earnings (or in another component of equity, as appropriate), without allocating the change between opening retained earnings and other components of equity.

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 lead 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 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 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 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?

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 this Directive' (Recital 9 of the IAS Regulation).

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

5 In its assessment, EFRAG has considered the Amendments from the perspectives of usefulness for decision-making and assessment of 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 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 including whether the Amendments lead to prudent accounting. EFRAG's assessment also includes assessing whether the amendments do not interact negatively with other IFRS and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 7 to 23;

(b) reliability: paragraphs 24 to 27;

(c) comparability: paragraphs 28 to 28;

(d) understandability: paragraphs 33 to 37;

(e) whether overall they lead to prudent accounting: paragraphs 38 to 40; and

(f) whether they would not be contrary to the true and fair view principle: paragraphs 41 to 43.

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 it would result in the omission of relevant information.

9 When assessing the criterion of relevance the requirements are analysed through the main issues in the Amendments:

(a) existence of a deductible temporary difference upon decrease in fair value;

(b) recovering an asset for more than its carrying amount;

(c) probable future taxable profit; and

(d) combined versus separate assessment.

10 The issue in paragraph 9(a) relates to whether a deductible temporary difference exists upon a decrease in fair value of a debt instrument. The issues in paragraph 9(b) to (d) relate to determining the extent of probable future taxable profits against which the deductible temporary differences can be utilised. They are applicable generally, i.e. they are not limited to debt instruments.

Existence of a deductible temporary difference upon decrease in fair value

11 The Amendments clarify that the difference between the carrying amount of a debt instrument measured at fair value and its tax base gives rise to a deductible temporary difference. This is irrespective of whether an entity expects to recover the carrying amount of the debt instrument by sale or by holding it.

12 EFRAG notes that this requirement is aligned with the definition of temporary differences which refers to differences between the carrying amount of an asset or a liability in the statement of financial position and its tax base. The economic benefit embodied in the deferred tax asset related to unrealised losses may be realised when the asset is sold and the selling loss, being the difference between the fair value and the nominal amount, reduces the taxable profits or through holding the instrument and collecting the cash flows. This will bring gains on the instrument as the fair value reverts to the nominal amount while no taxes will be paid on such gains.

13 EFRAG considers that the requirement aligns the recognition of deferred tax assets with the recognition of revaluation losses and therefore provides predictive value in respect of future tax consequences resulting from the carrying amount of assets.

Recovering an asset for more than its carrying amount

14 EFRAG considers that estimates of future taxable profits should not be limited by the carrying amount of the assets. This is because profits are generally generated by the assets and the carrying amount does not play a role in limiting them. However, the potential for bringing profits may be limited for assets measured at fair value in respect of subsequent increases in their carrying amount.

15 EFRAG assesses that the Amendments reflect this by requiring that sufficient evidence is necessary for concluding that such assets can be recovered for more than their carrying amount, including an example of how this would be met for a fixed-rate debt instrument.

16 As a result, EFRAG considers that the requirement enhances the predictive value of information about deferred taxes since it ensures that deferred tax assets arising from unrealised losses are not recognised if the losses are not expected to reverse and bring taxable profits.

Probable future taxable profit

17 The Amendments specify that, when evaluating whether an entity will have sufficient taxable profits in future periods, the tax deductions which will arise when those deductible temporary differences reverse are excluded from the future taxable profit.

18 EFRAG considers that when evaluating the sufficiency of future taxable profits they should not be decreased by the deductions resulting from reversal of deductible temporary differences. For example, if a deductible temporary difference exists in the amount of 100 and future taxable profit, including the deduction resulting from the reversal of the temporary difference, is estimated as zero this should not prevent the recognition of a deferred tax asset arising from the deductible temporary difference.

19 The recognition of the deferred tax asset would be appropriate because the deductible temporary difference reverses in the future, i.e. it is deducted from the taxable profits on which taxes are payable (which would be zero). The deduction brings a tax benefit against which the temporary difference can be utilised. The requirement in the Amendments would increase the estimated taxable profit to 100 and make the recognition of the deferred tax asset possible.

20 EFRAG considers that this requirement aligns the recognition of deferred tax assets with the real extent of estimated future taxable profits against which the deductible

temporary difference can be utilised. This helps in predicting income tax consequences resulting from entity's assets or liabilities.

Combined versus separate assessment

21 EFRAG assesses that deductible temporary differences arising on assets measured at fair value are no different to other cases of deductible temporary differences. For example, recognition of a deferred tax asset on a debt instrument with an unrealised loss would not be automatically warranted by the fact that the reversal of a deductible temporary difference occurs simultaneously with the recognition of a gain from an increase in fair value when holding the instrument and collecting the cash flows. As a result, all temporary differences should be considered collectively when evaluating sufficiency of future taxable profits unless tax law restricts the sources of taxable profits against which deductible temporary differences can be deducted when they reverse (such as capital losses might only be offset against capital gains).

22 This ensures that deferred tax assets are recognised only against those sources of probable future taxable profits which are available to offset the tax deductions from the related temporary differences. In EFRAG's view this contributes to the predictive value of the deferred tax asset information.

Overall assessment

23 EFRAG's overall assessment is that the requirements in the Amendments will result in relevant information in that they enhance the predictive value of information about deferred tax assets.

Reliability

24 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.

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

26 EFRAG assesses that the Amendments remove elements of subjective estimates and judgements and ensure that the information is free from material error and bias since they specify:

(a) in what cases it is appropriate to assume that an asset measured at fair value will be recovered for more than its carrying amount when estimating probable future taxable profits;

(b) treatment for cases when tax law restricts the sources of taxable profits against which deductions on the reversal of deductible temporary differences can be made; and

(c) how tax deductions which arise when deductible temporary differences reverse are included in estimates of future taxable profits.

27 Consequently, EFRAG's overall assessment is that the Amendments result in reliable information.

Comparability

28 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.

29 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.

30 EFRAG assesses that the Amendments clarify existing requirements of IAS 12 and reduce the existing diversity in practice when the requirements are applied to recognition of deferred tax assets arising from unrealised losses. Specifically, the Amendments address the diversity in practice in respect of:

(a) whether the deferred tax asset should be recognised for deductible temporary differences; and

(b) determining the extent of probable future taxable profit against which the deductible temporary differences can be utilised.

31 Regarding the transition requirements, EFRAG notes that retrospective application as required by the Amendments leads to comparability of information from the time that the Amendments are applied. EFRAG assesses that the exception which allows not to distinguish between specific components of opening equity of the earliest comparative period presented is not expected to result in a significant loss of information and is substantiated on cost / benefit grounds.

32 EFRAG considers that the Amendments address existing divergence in respect of recognition of deferred tax assets on unrealised losses. This will bring consistency in accounting for these transactions, and therefore will increase comparability between entities. Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

33 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.

34 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.

35 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.

36 The Amendments introduce more detailed requirements in the area of recognition of deferred tax assets on unrealised losses. They ensure that the recognition is aligned with the principle that temporary differences arise when there is a difference between the tax base and the carrying amount of an asset or liability. Further, the recognition of deferred tax assets is better aligned to the actual extent that probable future taxable profits are available to offset the tax deductions from the related temporary differences. As a result, EFRAG considers that users can be more confident in the financial information reported in respect of deferred tax assets.

37 EFRAG's overall assessment is that the requirements in the Amendments will result in information that is understandable.

Prudence

38 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.

39 The Amendments focus on clarifications in respect of uncertainties which existed in respect of the recognition of deferred tax assets for unrealised losses. EFRAG assesses that the requirements were introduced within the context of existing principles for recognition and measurement of deferred taxes. They ensure that the recognition and measurement of deferred tax assets is better aligned to the actual extent that the probable future taxable profits are available to offset the tax deductions from the related temporary differences.

40 Based on all of the above, EFRAG has concluded that the application of the Amendments will lead to prudent accounting.

True and Fair View Principle

41 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, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that 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.

42 EFRAG has assessed that, on a stand-alone basis, the Amendments provide relevant, reliable, comparable and understandable information and their application will lead to prudent accounting. EFRAG has also assessed that, in interacting with other IFRS, the Amendments do not lead to unavoidable distortions or significant omissions. EFRAG notes that the Amendments do not include any disclosure requirements. All disclosures necessary are provided through the specific disclosure requirements in IAS 12 and the general disclosure requirements in IFRS.

43 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

44 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 adopt 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 as a whole;

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

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

2 These assessments allow EFRAG to draw an intermediate conclusion as to whether the Amendments are likely to be conductive to the European public good. If the assessment concludes to a net benefit, the new IFRS will be conductive to the objectives of the IAS Regulation, i.e. improve the transparency and comparability of financial reporting.

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

3 EFRAG notes that the Amendments are designed to clarify how to apply existing principles of IAS 12 *Income Taxes* in respect of recognition of deferred tax assets for unrealised losses. They bring guidance that reduces divergence in practice in respect of:

(a) whether the deferred tax asset should be recognised for deductible temporary differences arising on unrealised losses; and

(b) determining the extent of probable future taxable profit against which the deductible temporary differences can be utilised.

4 As noted in Appendix 2, the Amendments reduce the subjectivity of estimates and judgements in this area. As a result, the Amendments enhance the predictive value of information about deferred taxes.

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 in applying the Amendments. 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.

Cost for preparers

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

ONE-OFF COSTS

8 EFRAG assesses that entities may incur costs related to the identification and assessment of deductible temporary differences if tax law restricts the sources of taxable profits against which the temporary differences can be deducted. Entities will have to adjust their software systems used for calculation of probable future taxable profits to enable such separate assessment.

9 One-off costs will also result from the transition requirements for restatement of the information for the comparative period(s). Entities will need to adjust or recalculate previous estimates of future taxable profits. If separate assessment of deductible temporary differences is necessary this may also affect the extent to which previously recognised deferred tax assets have to be adjusted in the comparative period.

10 However, the calculations are generally mechanical in nature and the information necessary is already available to the entity. From this perspective, EFRAG assesses that the one-off costs of implementation for preparers are not expected to be significant.

ONGOING COSTS

11 EFRAG considers that ongoing costs will be largely decreased by the one-off implementation costs. Some additional ongoing costs will be incurred by entities for which tax law requires a separate assessment of deductible temporary differences. This will involve separate assessment of the availability of taxable profits including verification of those estimates.

12 Nevertheless the information is already available to the entity. For this reason EFRAG assesses that the Amendments are generally expected to result in insignificant ongoing costs for preparers.

OVERALL ASSESSMENT

13 Overall, EFRAG's assessment is that the Amendments are likely to result in insignificant costs for preparers related to implementation and ongoing costs of complying with the Amendments.

Costs for users

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

15 EFRAG considers that users may incur one-off costs related to understanding the new requirements. However, these requirements are a clarification of existing principles for recognition of deferred tax assets when applied to a specific case and therefore EFRAG expects these costs to be insignificant.

16 EFRAG does not expect users to incur ongoing costs.

17 Overall, EFRAG's assessment is that the Amendments are likely to result in insignificant costs for users which are limited to understanding the new requirements.

Benefits for users and preparers

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

19 EFRAG assessment is that users will benefit from the clarifications brought by the Amendments since it will increase comparability between entities. Further, recognition of deferred tax assets will be better aligned with the real extent of the probable future taxable profits against which the deductible temporary differences can be utilised. As a result, users will benefit from the more relevant and

understandable financial information in forecasting future cash flows resulting from income taxes.

20 Even when the advantages for preparers may not be direct, they would benefit from their financial statements being prepared on a more relevant basis.

21 Overall, EFRAG's assessment is that users are likely to benefit from the Amendments, as the information resulting from it will increase comparability between entities and will improve financial reporting in respect of deferred taxes.

22 EFRAG's assessment is that preparers are likely to benefit from the Amendments through improved financial statements.

Conclusion on the costs and benefits of the Amendments

23 EFRAG's overall assessment is that the overall benefits of the users resulting from improved financial information being available on a more relevant and understandable basis are likely to outweigh costs of preparers associated with implementation of the Amendments and ongoing costs of complying with the Amendments which are considered as insignificant.

Conclusion

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

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

26 Furthermore, EFRAG has considered whether there are any other factors that could mean that adoption is not conducive to the public good and has not identified any such factors.

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