Note to EFRAG Board members

This document shows in mark-up the drafting changes recommended by TEG members in their sessions held on 24August, when they approved the DEA.

EFRAG's Letter to the European Commission Regarding Endorsement of the *Interest Rate Benchmark Reform – Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)*

John Berrigan
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

15 September 2020

Dear Mr Berrigan

Endorsement of the *Interest Rate Benchmark Reform – Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)*

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 *Interest Rate Benchmark Reform – Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)* ('the Amendments') that was issued by the IASB on 26 August 2020. An Exposure Draft *ED/2020/1 Interest Rate Benchmark Reform—Phase 2 (Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)* was issued on 9 April 2020. EFRAG provided its comment letter on that Exposure Draft on 26 May 2020.

The objective of the Amendments is to assist entities with providing useful information to users of financial statements and to support preparers in applying IFRS Standards when changes are made to contractual cash flows or hedging relationships, as a result of the transition to alternative benchmark rates, in the context of the ongoing risk-free rate reform ('IBOR reform').

EFRAG notes that the IBOR reform is a worldwide exercise lead by the Financial Stability Board under the aegis of the G20. This global transition exercise aims at transforming the current interbank offered rates – used in many financial instruments - into more reliable risk-free rates with the aim of improving financial stability. EFRAG acknowledges the recent EC proposals to amend the EU Benchmarks Regulation which will empower EC to designate a replacement benchmark that covers all references to a widely used reference rate that is phased out, such as LIBOR, when this is necessary to avoid disruption of the financial markets in EU.

This letter reflects EFRAG's advice on the IASB's response to emerging accounting issues arising from this reform. The Amendments are the results of the second phase of the IASB project that deals with the accounting implications of the IBOR reform, which originated the Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7) issued by the IASB on 26 September 2019. They complement the first phase of the

project which dealt with pre-replacement accounting implications of the IBOR reform and which have been issued by the IASB in 2019.

The Amendments shall be applied retrospectively for annual periods beginning on or after 1 January 2021, with earlier application permitted. 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 is 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. We also have assessed whether entities should be allowed to early adopt the Amendments in accordance with the IASB's transition provisions.

The Amendments will enable entities to account for modifications necessary as a direct consequence of the IBOR reform under a practical expedient by replacing the original benchmark rate with the alternative benchmark rate when applying the effective interest rate method. In the absence of such an expedient, entities may have to derecognise or adjust the carrying amounts of the financial instruments that are the subbject of a change with recognition of a corresponding modification gain or loss in profit or loss. Such an outcome would not provide useful information, because it would not properly reflect the economics of the underlying financial instruments.

In addition, the Amendments provide several exceptions to the hedge accounting requirements so that entities will be able to update the formalisation of the hedging relationship in response to the replacement of the original benchmark rate and to continue with the hedging relationships after transition to the alternative benchmark rate. Also in this case, without the reliefs offered by the Amendments, the discontinuation of hedge accounting solely due to IBOR reform would not provide useful information because entities would not be able to reflect their ongoing risk management activities.

Additional disclosures will be required to assist users of financial statements in assessing the progress an entity has made on transitioning from IBOR to alternative benchmark rates.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

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

On the basis of the conclusions illustrated above, we recommend the Amendments for endorsement without further delay.

We bring to the attention of the European Commission that the effective date of the Amendments is 1 January 2021, with earlier application being permitted. We have been informed that the ability to apply the Amendments already during 2020 is crucial for preparers given the demand from preparers to progress with their transition to new benchmark interest rates by amending their contractual arrangements. Also,~~.~~ ~~Since~~ since Phase 1 of the IBOR reform was effective for annual periods on or after 1 January 2020 and so is currently being applied by most entities,~~might have been applied by some entities~~, the endorsement of the Phase 2 should follow as rapidly as possible permitting entities to early adopt the amendment in 2020 thus avoiding discontinuance of ~~hedging~~hedge accounting. Consequently, EFRAG has accelerated the development of its endorsement advice in order to complete its part of the endorsement process as speedily as possible, facilitating a timely publication in the Official Journal.

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 Serious shortcomings in the previous legislative setup ~~Market developments over the last couple of years~~ have brought into question ~~the previous legislative setup~~ the long-term viability of some interbank offered rates (IBORs). IBORs (EURIBOR, LIBOR, etc.) are reference interest rates which are used as benchmarks for a broad range of financial products and contracts. In this context, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants. The FSB set out its recommendations for reforming major interest rate benchmarks in its July 2014 report.[1]

2 In response, the European Benchmark Regulation (BMR) was issued in June 2016 and starting from 1 January 2022, only benchmarks that are compliant with the BMR may be used in the EU.

3 In analysing the accounting impacts from the benchmark reform, the IASB has identified two types of implications:

(a) Issues affecting financial reporting in the periods before replacement of an existing interest rate benchmark with an alternative interest rate (pre-replacement issues); and

(b) Issues affecting financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate (replacement issues).

4 ~~While t~~The issues faced by entities before the replacement of existing interest benchmark (pre-replacement issues) were dealt with under the so-called Phase 1 amendments (issued by the IASB in September 2019 and endorsed in January 2020). This [Draft] Endorsement Advice addresses the~~, the~~ so-called Phase 2 of the IASB project, which resulted in the amendments issued in August 2020. ~~The latter addressed in the [Draft] Endorsement advice focus on the issues that affect financial reporting on replacement of an existing interest rate benchmark (replacement issues) and are addressed in the [Draft] Endorsement advice.~~

The issue and how it has been addressed

5 The replacement issues identified relate to modifications of financial instruments and lease contracts, amendments of hedging relationships and application of hedge accounting.

6 Accounting issues arise from replacement of an existing benchmark rate because the contractual cash flows are modified, i.e. change in a way that was not foreseen on initial recognition. While there is already currently established accounting practice on accounting for modifications, the assumption that IBOR reform represents a movement in a market rate of interest provides relevant information and at the same time ~~is also reducing~~ will reduce operational burden for preparers.

7 The Amendments would provide a practical expedient ~~to~~ regarding the accounting for changes in the expected cash flows, under certain circumstances, as a result of the IBOR reform, by replacing the original benchmark rate with the alternative benchmark rate when applying the effective interest rate method instead of the modification accounting mentioned in the preceding paragraph.

[1] The FSB report 'Reforming Major Interest Rate Benchmarks' can be found here.

8 In some cases, solely due to those modifications, entities could be required to discontinue hedging relationships that would otherwise qualify for hedge accounting. Discontinuation of a cash flows hedge would in some cases require an entity to recognise gains or losses in profit or loss instead of reflecting the ongoing risk management objective for the hedging relationships.

9 Therefore, the IASB has granted a practical expedient to modifications that are necessary as a direct consequence of the IBOR reform, together with exceptions to specific hedge accounting requirements in IFRS 9 and IAS 39, in order to provide relief when IBOR is replaced by an alternative benchmark rate. The proposed relief will allow entities to continue hedge accounting and to reflect alternative benchmark rates in the hedging relationships affected.

What has changed?

Modifications as direct consequence of the IBOR reform

10 According to IFRS 9, a financial instrument is considered to be modified for accounting purposes if, after its initial recognition, the basis for determining the contractual cash flows is changed~~, after the initial recognition of that financial instrument~~. In this context, the amendments to IFRS 9 clarify that a modification arises even if the contractual terms of the financial instrument are not amended. This clarification is limited in scope and applies only to changes made as a direct consequence of the IBOR reform.

11 The Amendments introduce a practical expedient allowing an entity to apply paragraph B5.4.5 of IFRS 9 to account for modifications of ~~a~~ financial instruments directly related to the IBOR reform instead of applying the established accounting practice for modifications.

12 Applying this practical expedient, an entity accounts for a modification required by the IBOR reform as a 'movement in the market rates of interest' and, hence, updates the effective interest rate accordingly. As a result, an entity neither derecognises the financial instrument, nor adjusts its carrying amount and recognises a modification gain or loss.

13 The scope of the practical expedient is limited and does not encompass other changes that would lead to value transfer between parties to the financial instrument. Instead, the practical expedient applies only to modifications that satisfy both conditions:

(a) the modification is necessary as a direct consequence of the reform; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis.

14 Some entities may effect the reform through the activation of the existing contractual terms, such as fallback provisions that are specified and had been contemplated in the existing contract and hence do not constitute a modification. To avoid a diversity of accounting outcomes for contracts with and without fallback clauses, the practical expedient also applies to revisions of an entity's estimates of future cash payments or receipts arising from the activation of existing contractual terms that are required by the IBOR reform.

15 IFRS 4 permits an insurer that meets specific criteria to apply IAS 39 for annual periods beginning before the effective date of IFRS 17 *Insurance Contracts* (temporary exemption from applying IFRS 9). Because of the temporary nature of this exemption, IAS 39 (except for its hedge accounting requirements) would not be updated for any subsequent amendments to other IFRS Standards.

16 Therefore, the IASB amended IFRS 4 to require insurers applying the temporary exemption from IFRS 9 to apply requirements that are comparable to the

requirements described in paragraphs 11 - 14 above to financial instruments that are modified as a result of the reform. This enables insurers to benefit from the practical expedient provided by the IASB as well.

17 For lease contracts, a practical expedient to lessee accounting is granted. Entities will be ~~that~~ required~~s~~ to remeasure~~ment of~~ the lease liability using a discount rate that reflects the change to the basis for determining the variable lease payments, as required by the reform. This practical expedient applies to all lease modifications that change the basis for determining future lease payments as a result of the IBOR reform. For this purpose, consistent with the amendments to IFRS 9, a lease modification has to satisfy both conditions ~~—~~the modification is necessary as a direct consequence of the reform and the new basis for determining the lease payments is economically equivalent to the previous basis (i.e. the basis immediately preceding the modification).

Hedge Accounting

18 The amendments to IFRS 9 and IAS 39 require that, as and when the respective Phase 1 requirements cease to apply and the original benchmark rate is replaced by an alternative benchmark rate, an entity amends the formal designation of the hedging relationship as previously documented to make one or more of the following changes:

(a) designating the alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

(b) amending the description of the hedged item so it refers to the alternative benchmark rate;

(c) amending the description of the hedging instrument so it refers to the alternative benchmark rate; or

(d) amending the description of how the entity will assess hedge effectiveness (for IAS 39 only).

19 When amending the description of the hedged items for a group of hedged items under the Amendments, an entity allocates the hedged items to subgroups based on the benchmark rate to which they are referenced and designates the benchmark rate for each sub-group as the hedged risk. An entity applies the proportionality test required by the standard to each subgroup separately.

20 When the hedge designation of a fair value hedging relationship is amended, under the Amendments an entity remeasures the hedging instrument and the carrying amount of the hedged item based on the alternative benchmark rate designated as the hedged risk and recognises a corresponding gain or loss in profit or loss.

21 When the hedge designation of a cash flow hedging relationship is amended, under the amendments the separate component of equity associated with the hedged item is remeasured to the lesser of

(a) the cumulative gain or loss on the hedging instrument calculated based on the alternative benchmark rate; and

~~(a)~~(b) the cumulative change in fair value of the expected future cash flows on the hedged item calculated based on the alternative benchmark rate.

~~21~~22 An amendment to IAS 39 permits an entity, for the purpose of the retrospective assessment only, to reset to zero the cumulative fair value changes of the hedged item and hedging instrument when the exception from the retrospective assessment ceases to apply in accordance with Phase 1 requirements.

~~22~~23 According to the Amendments, when an alternative benchmark rate is designated as a non-contractually specified risk portion that is not separately identifiable at the date it is designated, under the amendments to IFRS 9 and IAS 39 it shall be

deemed to have met that requirement at that date, if an entity reasonably expects that the alternative benchmark rate will be separately identifiable within a period of 24 months from the date the alternative benchmark rate is designated as a risk portion for the first time.

Disclosures

~~23~~24 Additional disclosure requirements were added to IFRS 7 with the objective of enabling users of financial statements to assess the nature and extent of risks arising from interest rate benchmark reform to which an entity is exposed, and how it manages those risks. In addition, the disclosures should assist users in assessing an entity's progress in completing the transition to alternative benchmark rates, and how an entity is managing that transition. The Amendments require specific quantitative information on financial instruments that have still to transition and on financial instruments that have already transitioned to alternative benchmark rates.

When do the Amendments become effective?

~~24~~25 The amendments have an effective date of annual periods beginning on or after 1 January 2021. Earlier application is permitted.

~~25~~26 An entity will be required to apply the amendments retrospectively. This includes a requirement to reinstate a discontinued hedging relationship if and only if an entity had discontinued that relationship solely because of changes necessary as a direct consequence of IBOR reform, and, at the date of initial application of the Amendments, that discontinued relationship still met the risk management objective on the basis of which it qualified for hedge accounting.

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 this Directive'* (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.

Relevance

6 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.

7 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.

8 In assessing the relevance EFRAG has considered the following key requirements in the Amendments:

(a) Practical expedients on the accounting for modifications;

(b) Amendments to existing hedging relationships;

(c) Application of hedge accounting;

(d) Hedge accounting – reflecting the spread;

(e) Disclosure requirements; and

(f) Effective date and transition requirements.

Practical expedients on the accounting for modifications

9 In absence of the practical expedient on modifications brought in by the Amendments, the ~~I~~modification requirements in IFRS 9 together with established practice would apply to financial instruments, resulting in derecognition of the financial instruments or adjustment of their gross carrying amount with recognition of a corresponding modification gain or loss in profit or loss. Such an outcome would not provide useful information to users of financial statements. This is because it may result in profit or loss impacts that do not reflect economic change and are complex to assess by users of financial instruments. In particular, when a financial instrument is amended to only replace an interest rate benchmark with an alternative benchmark rate due to the IBOR reform and the contractual amendment is made on an economically equivalent basis, derecognition would be ~~unlikely~~ inappropriate because the contractual cash flows are not substantially different. Applying the original IBOR-based effective interest rate to calculate interest revenue or interest expense in this situation would not reflect the economic effects of the modified financial instrument after transition to an alternative benchmark rate. Also, maintaining the original effective interest rate could be difficult, and perhaps impossible, if that rate is no longer available.

10 EFRAG considers that the practical expedient under IFRS 9 allowing to account for a modification required by the IBOR reform as a 'movement in the market rates of interest' provides relevant information because the interest revenue or expense after transition to an alternative benchmark rate is determined based on this benchmark rate and hence properly reflects the economics of the financial instrument.

11 As a further result of the practical expedient, an entity neither derecognises the financial instrument, nor adjusts its carrying amount and recognises a modification gain or loss. EFRAG observes that this avoids that IFRS financial statements ~~providing~~ provide ~~reporting with~~ limited information value from the application of those requirements, in the narrow context of modifications necessary from the IBOR reform.

12 EFRAG also considers that the Amendments to IFRS 16 *Leases* and IFRS 4 *Insurance Contracts,* made for similar reasons as the Amendments in relation to the practical expedient to IFRS 9, will provide useful information to users of financial statements and at the same time significantly reduce the operational burden on preparers, and hence increase relevance.

Amendments to existing hedging relationships

13 Amending the formal designation of a hedging relationship to reflect changes required by the IBOR reform may result in the hedging relationship being discontinued. This is because both IFRS 9 and IAS 39 require the formal designation of a hedging relationship to be documented at inception as part of the qualifying criteria for hedge accounting to be applied. Although in limited circumstances, IFRS 9 permits the hedge documentation to be updated without resulting in the discontinuation of hedge accounting, IAS 39 generally requires hedge accounting to be discontinued when amendments are made to the hedge designation.

14 Discontinuing hedge accounting solely due to effects of the IBOR reform on the formal designation would not reflect the economic effects of the changes to a

hedging-relationship and therefore would not provide relevant information to users of financial statements.

15 For these reasons the Amendments provide exceptions to the current requirements in IFRS 9 and IAS 39, permitting the entity to amend the formal designation of the hedging relationship to make one or more of the following changes: (a) designating the alternative benchmark rate (contractually or noncontractually specified) as a hedged risk; (b) amending the description of the hedged item so it refers to the alternative benchmark rate; (c) amending the description of the hedging instrument so it refers to the alternative benchmark rate; or (d) amending the description of how the entity will assess hedge effectiveness (for IAS 39 only).

16 The Amendments will enable an entity that has modified financial instruments as directly required by the IBOR reform to continue the hedging relationships affected, despite the changes needed to the formal designation of the hedges. In addition EFRAG notes the targeted modifications result solely from changes related to the IBOR reform and are done on an economically equivalent basis.

17 EFRAG considers that discontinuation of hedging relationships solely because of the need to update the hedging documentation has to be amended to reflect the transition of the instruments to the alternative benchmark rate would not provide relevant information to the users of financial statements.

18 Therefore, EFRAG supports the Amendments as they would permit an entity to amend the formal designation to reflect the change to alternative benchmark rate without requiring discontinuation of underlying hedging relationships.

19 In case of groups of items designated as hedged items, the Amendments permit an entity to amend the hedge documentation to define the hedged items by way of two subgroups within the designated group of items and apply the requirements for group designations to each group separately. One group would be referencing the original interest rate benchmark and the other the alternative benchmark rate. In addition, both rates would be treated as if they share similar risk characteristics.

20 EFRAG considers that such treatment provides relevant information as it enables entities to reflect the transition to an alternative benchmark rate within a group of hedged items without amending the key requirements for designation of groups of hedged items, in particular in terms of the requirement on similar risk characteristics of the items within a group, that apply in such cases.

Application of hedge accounting

21 The amount accumulated in the cash flow hedge reserve at the date that the entity amends the description of the hedged item is remeasured and deemed to have been since the inception of the hedge based on the alternative benchmark rate on which the hedged future cash flows are determined, i.e. the cumulated amount is not reclassified from OCI to profit or loss. EFRAG is of the view that this leads to relevant information as ~~the~~ it allows treating hedges under the scope of the Amendments as continuing hedges. The ~~cash flow hedge reserve is not subject to separate measurement requirements, but is derived from the cumulative changes in the fair values of the hedged item and hedging instrument. In addition, it allows treating hedges under the scope of the Amendments as continuing hedges which is consistent with the relief provided.~~

22 In applying the Amendments to groups of items designated as hedged items in a hedging relationship, the entity shall allocate the hedged items to subgroups based on the benchmark rate being hedged. One group would be referencing the original interest rate benchmark and the other would be referencing the alternative benchmark rate. EFRAG considers this leads to relevant information because, irrespective of the scope of the proportionality test, EFRAG considers the change in fair value attributable to the hedged risk for each individual item in the group is

expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.

23 For the purpose of assessing retrospective effectiveness as required by IAS 39, the Amendments allow for a practical expedient whereas the cumulative fair value changes of the hedged item and the hedging instrument may be reset to zero when designation as a hedged item stops. EFRAG considers this leads to relevant information as in the cases where it is applied it provides relief from failing the effectiveness assessment in IAS 39 solely due to ineffectiveness caused by uncertainty arising from the reform.

Hedge accounting – reflecting the spread

24 The requirement to remeasure the hedged item for the new hedged risk, based on an alternative benchmark rate, could result in a difference being recognised in profit or loss in a fair value hedge. This profit or loss impact is considered by some as not representing ineffectiveness. EFRAG is sympathetic with this view but notes that in accordance with the Amendments, modifications to a financial instrument in scope of the reliefs are to be made on an economically equivalent basis, ie there is no or only an insignificant realisation of economic value and as a result no or insignificant profit or loss impact.

25 EFRAG understands that the contractual amendments due to IBOR reform may take various forms in practice. In particular, some central counterparties intend to settle the measurement difference through cash balances or basis swaps, rather than identifying a credit spread. EFRAG notes that the choice for a particular transition approach is a choice between contractual parties and not required by IFRS. EFRAG is of the view that this voluntary practice is outside the scope of the IASB's intended scope of the reliefs.

26 Other parties may identify a day one profit or loss impact as a result of a particular transition approach and for some of these parties with an important derivatives portfolio, this impact may be material. Notwithstanding this fact, EFRAG remains of the view that modifications are to be made in relation to the individual financial instruments affected on an economically equivalent basis with no or only an insignificant realisation of economic value and on balance considers the requirements lead to relevant information.

Disclosure requirements

27 The Amendments added limited additional disclosure requirements to IFRS 7 with the objective of enabling users of financial statements to assess the progress an entity has made on transition to alternative benchmark rates. The amendments require specific quantitative information on financial instruments that have still to transition and on financial instruments that have already transitioned to alternative benchmark rates.

28 EFRAG is of the view that disclosures of the impacts of the reform provide relevant information to users and therefore supports the disclosure requirements. The disclosures enhance the transparency of the impacts of the IBOR reform and in doing so support the European public good. EFRAG also relies on the general disclosure requirements in IAS 1 *Presentation of Financial Statements* that mandate the provision of additional information where necessary.

29 In addition, in the reporting period in which an entity first applies the Amendments, entities are exempted from the presentation of the quantitative information required by paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors which requires an entity, on the initial application of an accounting policy, to disclose, for the current period and each prior period presented, the amount of any adjustment for each financial statement line item affected.

30 EFRAG considers that the above IAS 8 requirement would not provide useful information to users of financial statements because the new risk free reference rates in many cases were either still being developed or did not exist at that time and the contractual modifications did not occur at that time. In addition it would be unduly onerous for preparers as the cost for developing such disclosures would outweigh the limited benefits that can be derived from it.

Effective date and transition requirements

31 As IBOR reform is progressing at a different speed within different jurisdictions, it is important to provide level playing field for all the entities. To achieve this, entities need to be able to use the Amendments as soon as possible. EFRAG notes that the transition in Europe is expected to happen with significant volumes already during 2020. Hence it is important that the effective date of 1 January 2021 with an earlier application permitted is available to the preparers of financial statements.

32 Therefore, considering the publication date of the Amendments [27 August 2020], EFRAG assesses that the effective date proposed in the Amendments with an earlier application permitted together with retrospective application of the Amendments results in information relevant to the users of financial statements.

Conclusion

33 EFRAG's overall assessment is that the requirements in the Amendments will result in relevant information.

Reliability

34 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.

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

36 In assessing the reliability EFRAG has considered:

(a) *Mandatory application of the Amendments; and*

(b) *Discontinuation of hedging relationships.*

Mandatory application of the Amendments

37 The application of the Amendments is mandatory for all hedging relationships affected by interest rate benchmark reform. EFRAG considers that the mandatory application avoids earnings management and therefore results in more reliable information.

Discontinuation of hedging relationships

38 The objective of the Phase 2 amendments is to ensure the continuation of the existing hedging relationships, which in EFRAG's view provides a reliable information to the users of financial statements about the impacts of the reform on an entity and its risk management policy, as the IBOR reform doesn't impact the risk management objectives.

Conclusion

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

Comparability

40 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.

41 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.

42 In assessing comparability, EFRAG has considered:

(a) Documentation of hedging relationships;

(b) Transition requirements. and

(c) Cash flow hedge: resetting cumulative fair values to zero

Documentation of hedging relationships

43 EFRAG observes that the Amendments provide requirements for the changes to the hedging documentation reflecting the transition to the alternative benchmark rates. EFRAG highlights that in limited circumstances, IFRS 9 permits the hedge documentation to be updated without resulting in the discontinuation of hedge accounting, IAS 39 requires hedge accounting to be discontinued when any amendments are made to the hedge designation.

44 The Amendments allow the continuation of hedging relationship despite the changes made to the hedging documentation and therefore ensure the comparability of the hedging results between the different reporting periods.

45 Therefore, EFRAG supports the Amendments to the documentation of the hedging relationships as a result of the IBOR reform as they improve comparability.

Transition requirements

46 As the application of the Amendments is mandatory, it results in different accounting outcomes for the financial instruments that are not and for financial instruments that are affected by the IBOR reform when these instruments are modified or designated in a hedging relationship. However, in EFRAG's view, the possible reduced ability to differentiate between the two different types of instruments is mitigated by the short-term nature of the reform and the additional disclosures required by the Amendments.

47 The mandatory application also removes the possibility to apply the Amendments selectively and ensures that the transition to the alternative benchmark rates is treated similarly by all the entities affected by the reform and therefore, enhances comparability.

48 EFRAG notes that application of the Amendments is limited in time because they only apply on transition from the old to an alternative benchmark rate. As an exception to this, the expedient to the separately identifiable criterion is applicable only for 24 months after a particular alternative benchmark rate was designated for ~~this~~ the first time. By stating an end point on the applicability of the Amendments, comparability is enhanced, as once the transition has occurred or the 24 months have passed, entities will stop applying the Amendments.

49 The Amendments require the reinstatement of hedging relationships that had previously been discontinued because entities were unable to apply the amendments on transition from the old to an alternative benchmark rate. EFRAG is working on the assumption that the Endorsement is completed before the date of

issuance of 2020 reporting and as a result the Amendments will be available for use in Europe for the 2020 financial statements.

50 Accordingly, EFRAG considers that comparability of the financial statements of most European constituents with their non-European counterparts is ensured.

Cash flow hedge: resetting cumulative fair values to zero

51 Dealing with cash flow hedges, the Amendments to IAS 39 permit an entity to reset cumulative fair value changes to zero for the purpose of performing the retrospective effectiveness assessment. EFRAG understands this is because this treatment may impact the results of the effectiveness test. This implies that some entities may use this resetting while others will not do so.

52 EFRAG considers this may lead to results that are not comparable. A mandatory application would have been purer conceptually but would have required a recalculation of what the cumulative fair value changes would have been if the hedged item ~~was~~ had been based on the alternative benchmark rate from inception. Doing so may be difficult in some circumstances, leading to excessive costs compared to the benefits that can be derived from the results. Hence, EFRAG accepts this lack of comparability as a practical solution.

~~52~~53 In addition, EFRAG observes that comparability is increased by the Amendments to IAS 39 in that an entity assesses effectiveness for a continuing hedging relationship that has been transitioned from IBOR to an alternative benchmark rate in the same way as an entity that has designated the same hedging relationship already under the alternative benchmark rate, i.e. did not transition from IBOR.

Conclusion

~~53~~54 EFRAG's overall assessment is that the requirements in the Amendments will on balance result in sufficiently comparable information.

Understandability

~~54~~55 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.

~~55~~56 In assessing understandability, EFRAG has particularly considered the following specific subtopics:

(a) Practical expedients on modifications;

(b) Documentation of hedging relationships

(c) Disclosure requirements; and

(d) Transition requirements.

Practical expedients on modification

~~56~~57 When an entity transitions from the old to an alternative benchmark rate, EFRAG concludes that the practical expedients on modification contribute to understandability in that users of financial statements can better assess interest revenue or interest expense. Applying the practical expedients, these figures are based on the alternative benchmark rate because of the application of "movements in market interest rates" guidance rather than the guidance on modifications. In absence of the Amendments, understandability would be impaired when interest revenue or interest expense were driven by IBOR for accounting purposes only while, after transition to an alternative benchmark rate, IBOR no longer reflected the actual economic characteristics of the underlying items affected.

Documentation of hedging relationships

5758 When an entity transitions from the old to an alternative benchmark rate, the Amendments enable an entity to continue the underlying hedging relationship while absent the amendments, an entity will likely have to discontinue the hedging relationship.

5859 EFRAG concludes that discontinuation of hedging relationships solely as a consequence from transitioning to an alternative benchmark rate as necessary by the IBOR reform would impair understandability. Hence, the Amendments increase understandability because entities do not have to discontinue hedging relationships.

Disclosure requirements

5960 EFRAG considers that the additional disclosure requirements added to IFRS 7 increase understandability by enabling users of financial statements to evaluate the nature and extent of risks arising from interest rate benchmark reform to which an entity is exposed, and how it manages those risks.

6061 EFRAG notes that the disclosures increase understandability by helping users to assess an entity's progress in completing the transition from existing interest rates to alternative benchmark rates, and how an entity is managing that transition.

Transition requirements

6162 When an entity applies the Amendments for the first time, retrospective application will include reinstatement of hedging relationships that were discontinued solely because the amendments were not yet available for application but still reflect the risk management objective as documented at inception of the hedging relationship (apart from replacement of the existing rate by an alternative benchmark rate).

6263 When an entity has published (interim) financial statements before it first applied the Amendments, the accounting in these (interim) financial statements will be based on the requirements in existing IFRS standards. Hence, the general modification guidance will have been applied, and hedging relationships might have been discontinued on transition from the old to the new alternative benchmark rate.

6364 While understandability may be decreased when the accounting applied in (interim) financial statements changes in consecutive (annual) financial statements in which the amendments are applied retrospectively, as outlined above, application of the Amendments will have a positive impact on understandability compared to application of the current IFRS requirements. Hence, retrospective application including reinstatement of hedging relationships will mitigate the decreased understandability of the information provided in (interim) financial statements and will increase understandability once the Amendments are applied in consecutive (annual) financial statements.

Conclusion

6465 EFRAG's overall assessment is that on balance the Amendments satisfy the understandability criterion in all material respects.

Prudence

6566 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.

6667 EFRAG acknowledges that the Amendments might adversely affect prudence, as they allow entities to designate a risk component that is not contractually specified in relation to an alternative benchmark rate even if, on designation, the risk component is not separately identifiable as required by IFRS 9 or IAS 39 respectively. Such designation adversely affects prudence in that a risk component

can be designated although, on designation, it is not separately identifiable. However, this concern is mitigated by the requirement that such designation is permitted only when an entity has a reasonable expectation that the risk component will be separately identifiable within 24 months after it ~~is~~ was designated. While this is also subject to conditions of uncertainty and hence impacts prudence, an entity will have to assess its reasonable expectation throughout the 24 months period so that concerns on prudence are effectively mitigated.

Conclusion

~~67~~68 EFRAG's overall assessment is that the Amendments satisfy the prudence criterion in all material respects.

True and Fair View Principle

~~68~~69 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 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.

~~69~~70 The Amendments affect five IFRS Standards: IFRS 9, IAS 39, IFRS 4, IFRS 16 and IFRS 7 and do not create any negative interactions with other IFRS Standards. In EFRAG's opinion, any reduction in understandability and prudence is mitigated by the increased relevance of avoiding the impact on profit or loss from modification accounting and of unintended discontinuation of hedge accounting on transition from the old to alternative benchmark rates.

~~70~~71 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.

~~71~~72 EFRAG has concluded that the Amendments require appropriate disclosures about the impacts of the reform which would provide useful information for users and would not incur undue costs to preparers.

~~72~~73 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

~~73~~74 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 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 it/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 will 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 are designed to properly reflect the economic effects on and after transitioning from existing to an alternative benchmark rate and to ensure continuity of existing hedge accounting relationships and therefore provide short-term exceptions from the applicable requirements in IFRS 9, IAS 39, IFRS 4 and IFRS 16.

4 Without application of the Amendments, the replacement of existing by alternative benchmark rates would result in adjustments to carrying amounts of items affected by modification accounting. As a result, entities may encounter volatility in profit or loss, from failing hedge accounting relationships or the inability to designate new hedge accounting relationships. EFRAG is of the view that these effects do not result in useful information. Applying the Amendments will address these inadequacies.

5 EFRAG has therefore concluded that the Amendments will 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 fully understand 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.

Costs for preparers

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

8 EFRAG notes that the IBOR reform itself creates costs for preparers as they revisit their risk management approaches in light of new benchmark interest rates and make changes to the terms of financial instruments. EFRAG is of the view that the Amendments significantly contribute to simplify the added complexity created by the

need to assess the modification and consequential hedge accounting designation and effectiveness for a big number of transactions (those impacted by the IBOR reform) in a short timeframe. In addition, these Amendments are designed to ensure the continuity of existing hedge accounting, thus reducing accounting disruptions due to the IBOR reform.

9 With regard to the disclosure requirements, EFRAG observes that the disclosures proposed by the Amendments are not expected to generate significant costs for preparers.

10 Overall, EFRAG's assessment is that the Amendments will significantly reduce accounting complexity created by the IBOR reform and will not result in significant undue costs for preparers related to their implementation.

Costs for users

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

12 EFRAG does not expect significant additional costs for users as the existing hedge accounting requirements will be maintained and the users are already acquainted with the disclosures required by IFRS 7 *Financial Instruments: Disclosures*. The main cost for users would be understanding the entity's progress in completing the transition to alternative benchmark rates.

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

Benefits for preparers and users

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

15 The aim of the Amendments is to properly reflect the economic effects on and after transitioning from IBOR to an alternative benchmark rate and to ensure the continuity of the existing hedge accounting relationships affected by the IBOR reform. EFRAG is of the view that the Amendments improve the financial reporting requirements of IAS 39, IFRS 9, IFRS 4 and IFRS 16 as they remove accounting effects caused by transition to alternative benchmark rates as necessary due to the IBOR reform which do not properly reflect the underlying economic substance. Therefore, in EFRAG's view, users will benefit from financial information reflecting the underlying economic substance. The Amendments are expected to significantly reduce the operational burden on preparers. In addition, preparers will benefit from the Amendments which will help avoiding the undue disruption of the hedge accounting which would otherwise be caused by the IBOR reform.

Conclusion

16 EFRAG's overall assessment is that the benefits resulting from the Amendments are likely to outweigh costs associated with their implementation.

EFRAG's evaluation of impact on financial stability

17 The derivatives market in Europe amounts to over 735 trillion euros[2] (notional amounts) of which many are used in hedging and associated hedge accounting. It should be noted that neither IFRS 9 nor IAS 39 were written to cater for changes of benchmarks required by the reform, therefore the Amendments represent a response to this particular market development. The objective of the Amendments

[2] Source : ESMA Annual Statistical Report – EU Derivatives Markets 2019 (76% relating to interest rates, 15% currency derivatives, equity, credit and commodity derivatives count for less than 6% each)

is to properly reflect the economic results of transition to alternative benchmark rates without adversely impacting the quality of the information provided in IFRS financial reporting and, as a consequence, financial markets and the financial stability. Without the Amendments, the financial statements would not provide useful information about the transition to alternative benchmark rates and entities' reported profit or loss could be impacted significantly, potentially leading to real market impacts as the picture portrayed by financial statements would not depict the economic position of the entity including its risk management activities properly.

18 ~~It should be noted that neither IFRS 9 nor IAS 39 were written to cater for changes of benchmarks required by the reform, therefore the Amendments represent a response to this particular market development. Without the Amendments, entities' reported profit or loss could be impacted significantly, potentially leading to real market impacts.~~EFRAG further observes, more broadly, that the markets for alternative benchmark rates are in the process of being fully developed and confidence needs to be rebuilt, as the transition successfully progresses. If volatility of financial results of entities that have transitioned to alternative benchmark rates was increased in absence of the Amendments, this may unduly undermine this process of rebuilding confidence to the market.

19 The Amendments aim to mitigate unintended volatility in financial reporting and therefore EFRAG supports the Amendments as having a positive effect on financial stability. In addition, they contribute to facilitate the implementation of a relevant regulatory reform for EU entities which has been designed to overcome the issues of the interbank-based benchmark rates, by reducing the complexity of accounting for the modifications and hedge accounting disruptions resulting from the IBOR reform.

20 The timing of IBOR reform is different for different rates and jurisdictions but the terms of the different transitions, including how and when the old interest rates will cease and be replaced by new rates, are progressively being clarified. As a consequence, entities have been starting to arrange the change of their relevant contractual agreements in preparation of the transition. As a result of these market developments, EFRAG has received a clear message from all the interested parties that contributed to EFRAG assessment during the due process, that it is paramount to have the relief provided in the Amendments available as soon as possible. This resulted in adoption of an accelerated timing for the endorsement advice.

FASB – International level playing field

21 EFRAG notes that in the US the Financial Accounting Standards Board has been working on similar reliefs for US preparers in the specific context of the US market. EFRAG assesses that the application of the Amendments can increase the level playing field and comparability of financial statements of European preparers with their US counterparts even when not all detailed requirements are identical in both frameworks.

Conclusion

22 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to the unchanged requirements of IAS 39, IFRS 9, IFRS 4, IFRS 16 and IFRS 7. 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.

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

24 EFRAG further notes that completing the endorsement process as soon as possible is crucial in allowing preparers to benefit from the reliefs provided by the Amendments as this would reduce unintended negative consequences related to

the discontinuation of the hedges solely as a result of the transition to alternative benchmark rates.

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

26 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.