



The Voice of Leasing and Automotive Rental in Europe

Mr Jean-Paul Gauzès
EFRAG Board President

EFRAG

35 Square de Meeûs
1000 Brussels

7th December 2016

Dear Mr. Gauzès

Preparation of EFRAG opinion on IFRS 16 Leases

The response of Leaseurope, the voice of the leasing and automotive rental industries in Europe, to EFRAG's Preliminary Consultation Document on IFRS 16 is attached for your information, together with our letter to Mr. Watchman.

As set out in the attachments, Leaseurope is concerned that EFRAG's opinion on IFRS 16, when it is provided to the European Commission, may provide an incomplete analysis of the likely effects of IFRS 16 on both the use of leasing by European companies and on the overall level of business investment in Europe. We question whether the positions set out in the Consultation are consistent with EFRAG's previous statements and whether the scope of the analysis is sufficient to meet the Commission's request for an opinion on the European public good. We are also concerned that the points we raised at the EFRAG Board meeting regarding opportunities to mitigate the risks of IFRS 16 appear not to have been considered in the Preliminary Consultation.

We would be pleased to arrange a meeting to discuss our concerns and suggestions set out in more detail the attachments.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Leon Dhaene". The signature is stylized and somewhat abstract, with overlapping lines.

Leon Dhaene
Director General Leaseurope AISB



The Voice of Leasing and Automotive Rental in Europe

Andrew Watchman
EFRAG TEG Chairman and CEO

EFRAG

35 Square de Meeûs
1000 Brussels

CC

Jean-Paul Gauzes, EFRAG Board President
Erik Nooteboom, Head of Unit, Accounting and Financial Reporting, European Commission

7th December 2016

Dear Mr Watchman

Preliminary Consultation Document regarding the endorsement of IFRS 16 Leases

The response of Leaseurope, the voice of the leasing and automotive rental industries in Europe, to this Consultation is attached.

Based on this Consultation paper, Leaseurope is concerned that EFRAG's opinion on IFRS 16, when it is provided to the European Commission, may provide an incomplete analysis of the likely effects of IFRS 16 on both the use of leasing by European companies and on the overall level of business investment in Europe.

Our specific concerns include:

- The Consultation Paper is as complicated as the Standard it is consulting over. Very few European businesses and their representative bodies have the resource to consider and respond to this.
- The Consultation includes many strong opinions (such as the argument that the existing system of lessee accounting is "fundamentally flawed") that bear little resemblance to EFRAG's previous positions and for which there is scant evidence.
- The Paper acknowledges that not all EFRAG's suggestions to the IASB have been taken up in IFRS 16 but proceeds to set out a remarkably positive summary of the new Standard, as if the IASB was correct to dismiss EFRAG's input.

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- Evidence cited from academic studies is highly selective in supporting IFRS 16 and ignores studies providing the opposite view.
- The Consultation ignores the most significant impacts of IFRS 16 on SMEs that will be caused by:
 - The difficulties that national accounting standard setters would face in maintaining the existing lease accounting model for smaller firms alongside the new 'right of use' model being used by larger firms; and
 - The need to change both corporate income and European VAT tax rules and practices that are currently based on IAS 17 rules (including where Court judgements on the application of the VAT Directive have been made based on IAS 17 definitions) which could lead to major changes in incentives for business investment for SMEs.
- There is no consideration of options for reducing the impacts of IFRS 16, as suggested by Leaseurope at the EFRAG Board meeting in January, including:
 - Requiring the IASB to clarify its rules on 'substitutability' that are very complicated and unclear, and in effect shift the problem to the audit firms who can be expected to interpret them conservatively, leading to significant unnecessary costs for European companies.
 - Requiring the IASB to clarify its small asset exemption in a way that makes it a more useful way of reducing costs for European companies.
 - Requiring the IASB to clarify its requirements for the very extensive disclosures that will be very expensive to provide and will add considerable 'clutter' to many annual reports.
 - Reviewing the implementation timing to allow more time for European lessors and lessees the complex systems changes that will be required.

We appreciate that this Consultation is only one part of EFRAG's work to prepare its opinion on IFRS 16. We understand, however, that the consultants appointed by EFRAG to review, inter alia, the effects of IFRS on SMEs appear to have been asked to look at the "direct" impacts and not the wider concerns (as set out above) that will have a far greater impact on the European public good. Furthermore, we have doubts that at this stage many companies will be ready to provide fully informed answers to questions from the consultants about the potential impacts, as many lessors are finding that their customers have yet to start any detailed planning for IFRS 16.

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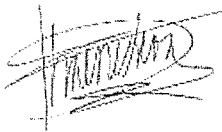
As we set out in our response, we believe EFRAG has been a strong voice in calling for, and in parts, achieving a better Standard. It seems vital that that EFRAG presents an independent and critical opinion on IFRS 16 to the Commission, rather than attempting to garner support for the IASB as the Consultation Paper appears to do in so many places.

European companies of all sizes, but particularly SMEs, cannot be expected to defend their own interests on such a technical and still distant regulatory matter as IFRS 16.

In our view EFRAG should consider both the direct and indirect impacts of IFRS 16 on all European companies, and the consequent risks to European business investment and Europe's competitiveness, if it is to provide the Commission with a complete analysis of the effects of IFRS 16 on the European public good.

Leaseurope stands ready to continue to assist EFRAG in its preparation of an opinion of the highest quality to the Commission. We would be pleased to arrange a meeting with you to discuss how we can provide such assistance.

Yours sincerely,



Leon Dhaene
Director General Leaseurope AISBL

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LEASEUROPE RESPONSE TO EFRAG'S PRELIMINARY CONSULTATION DOCUMENT ON THE ENDORSEMENT OF IFRS 16 LEASES DECEMBER 2016

About Leaseurope

Leaseurope is a trade association which brings together 46 member associations representing the leasing, long term and/or short term automotive rental industries in the 33 European countries in which they are present. The scope of products covered by Leaseurope members' ranges from hire purchase and finance leases to operating leases of all asset categories (automotive, equipment and real estate). It also includes the short-term rental of cars, vans and trucks. It is estimated that Leaseurope represents approximately 92% of the European leasing market. In 2015, total outstanding volume worth €729.5 billion and total new leasing volumes worth €274.2 billion were granted by the roughly 1400 firms represented through Leaseurope's members.

Introduction

We have, over the years, provided considerable input to EFRAG's consideration of the lease accounting project, including presenting at both Technical Expert Group and Board meetings. We have consistently attempted to describe the realities of the leasing business in Europe and have pointed out on numerous occasions that this reality is far removed from the business of big ticket leasing or structured leases of property or aircraft that has often been depicted by standard setters.

We have welcomed EFRAG's thorough critical analysis of the IASB's work and believe it has been a strong voice in calling for, and in parts, achieving a better Standard.

Unfortunately, there are some key areas of IFRS 16 where the IASB did not take account of EFRAG's concerns in full or at all. Our response focuses on these.

We start each section by comparing EFRAG's previous public statements with its views in the Preliminary Consultation Document. We strongly believe that EFRAG's original concerns and statements remain as valid as ever and should be reflected in the advice that EFRAG will provide to the Commission.

1. Relevance: Definition and identification of a lease

Significant judgement will be needed and unless entities are able to properly understand and apply the definition of a lease and the other requirements in the standard, there will be a significant and wasteful use of time debating possible interpretations, which will lead to a real risk of divergent application. (EFRAG letter to IASB, 'Public access to forthcoming Leases Standard', 15 June 2015)

In certain cases, judgement will be required to assess if a customer has obtained control over an identified asset. Such judgements are not dissimilar to those required by other IFRS Standards and are not more complex. (EFRAG 2016 Preliminary Consultation paragraph 20)

At paragraph 18 (a) EFRAG notes: "IFRS 16 requires the existence of an identified asset. One of the implications of this is that the supplier does not have the unilateral right and ability to replace an asset."

That may seem a perfectly reasonable statement, given that paragraph 9 of the Standard states that a lease "conveys the right to control the use of an identified asset...".

Our understanding however is that even if the supplier does have the unilateral right and ability to replace an asset there may still be a lease recognised unjustifiably under IFRS 16. Paragraph B16 of IFRS 16 restricts the circumstances under which the supplier's unilateral right and ability to replace an asset is considered 'substantive'.

It appears that the very reasons why lessors are likely to replace assets - for example because of a change to the customer's planned use of the equipment - are to be treated as 'non-substantive' (i.e. ineligible) on the basis they 'would not be considered likely to occur'.

The reasons cited in B16 are not only likely to occur, they are becoming more and more a feature of the European economy as finance companies and their customers work together to optimise the portfolio of equipment in use. It increases efficiency and allows assets to be recycled to other businesses where they are better suited. We cannot predict which specific assets in a portfolio are likely to be replaced or exactly how many, but we can reliably predict that some will be.

With this inherent contradiction in the final Standard EFRAG's concern in its letter of 15 June 2015 remains completely valid and should therefore form part of the advice to the Commission.

2. Relevance: Lessee accounting

This lack of clarity in the conceptual model...means in EFRAG's view that the current proposals will not lead to improvements in financial reporting. (EFRAG letter to IASB, 'Exposure Draft Leases', 14 October 2013)

Lessee accounting [is] deemed to be fundamentally flawed. (73) EFRAG's overall assessment is that the requirements in the IFRS 16, especially the recognition of assets and liabilities by lessees for all leases (with limited exceptions) will result in relevant information. (EFRAG 2016 para 85)

The right-of-use model barely changed from the 2013 Exposure Draft to the 2016 final Standard. There remain two fundamental problems with it.

First, there is no meaningful distinction between many contracts that will be classified as leases and others that will be classified as services. Leasing covers a spectrum of activity that runs from straightforward leases with no or little additional services to outsourcing arrangements where the service provided is the key feature and the availability of assets is simply ancillary to the service. To simplify, at one end are 'in-substance purchases', at the other end are 'in-substance service contracts'. Today, this does not matter as the accounting for operating leases (which are nearer in-substance service contracts) and service contracts is very similar. Under IFRS 16, minor differences in how similar contracts are drafted will lead to very different accounting values.

Second, two businesses leasing identical assets of the same age may have very different values in their accounts, depending on the outstanding term of the lease. This is not an issue for today's finance leases, but for today's operating leases with significant residual values it will make balance sheet comparisons between companies extremely difficult.

Given these are issues that have already been flagged prominently by EFRAG, and which were not addressed by the IASB, it is important that they form part of EFRAG's advice now to the Commission.

3. Relevance: Lessor accounting

The hybrid model for lessors replicates in substance the existing model in IAS 17; the justification for the performance obligation model contradicts the rationale for having lessees apply the right of use approach to all leases. EFRAG supports the right of use approach for lessees and a single partial derecognition model for lessors. (*EFRAG letter to IASB, Exposure Draft Leases, 15 December 2010*)

By retaining lease accounting for lessors based on the existing requirements of IAS 17, IFRS 16 does not provide symmetry between the lessee and lessor accounting models. EFRAG supports this approach..." (*EFRAG 2016, para 73*)

The IASB's eventual decision to maintain existing accounting rules for lessors fundamentally contradicts the Right of Use model. It is impossible to justify an argument that a lessor has transferred a valuable right to a lessee when the lessor retains the entire value of the underlying asset on its books.

The reason why lessor accounting had not changed is entirely because few believe that assets that are used for today's operating leases should not remain on the lessor's balance sheet. It cannot reflect concern over complexity for lessors (as suggested in the Consultation) because the complexity burden for lessees, who are likely to be far less able to cope, is much greater.

If there is any doubt over how odd the non-symmetric IFRS 16 solution to lease accounting is, consider how it will be explained to students training to become accountants. The students will be very justified in querying whether their textbooks can possibly be correct.

EFRAG was right to say in 2010, that any solution must make sense from both lessee and lessor perspectives. The fact that the IASB has not delivered this should be highlighted in the advice to be provided to the Commission.

4. Benefits

...it has not become clear in the course of the Board's project whether the proposals in the ED result in information that is useful to users of the financial statements of lessors. We would suggest that the Board confirm this as part of its outreach and field-testing activities. (*EFRAG letter to IASB, Exposure Draft Leases, 15 December 2010*)

During its due diligence, the IASB received significant support on lease capitalisation from users. Eleven comment letters from them were submitted on the 2013 Exposure Draft form users' organisations, out of total 641. Ten of the respondents supported capitalisation of leases... (*EFRAG 2016, para 32*)

As EFRAG highlighted in 2010, it is vital to confirm not only that users, including investors, support the project in general, but that they support the specific proposals being made.

Support from investors and other users has been limited from the start of the IASB's project. It tends to come from technical committees that, as a matter of general policy, can be relied upon to support the IASB's work. By any reckoning, eleven comment letters out of 641 is hardly a show of significant interest or support. EFRAG's considerable efforts to engage with investors, including its investor outreach meeting in 2016, are to be commended but do not appear to have been well-supported.

What is clear is that investors who have studied the details say they will still need to adapt accounting data to fit their cashflow models. All that can be said is that they may find their work easier.

For every academic study that can be cited to support the case for change (including several in the consultation paper) there are others that might be interpreted as suggesting the opposite. Spencer and Webb provide a wide-ranging review of the academic literature relating to leases¹. They note that "Despite concerns about off-balance sheet treatment, a substantial body of evidence indicates that users generally see through the accounting associated with these structures and price the underlying economics". It concludes that recognition [of operating leases] may cause negative economic consequences, and may lower the usefulness of financial statements.

It is not even as if IFRS 16 is replacing something that is broken. In Europe, there is zero evidence of 'structuring' (alleged manipulation of accounting rules to keep leases off-balance sheet). More positively, the distinction between operating and finance

¹ Spencer & Webb, 2015, *Leases: A Review of Contemporary Academic Literature Relating to Leases*

leases is well-understood and meaningful, even if there is always room for improvement.

The debate of the past ten years has confirmed there is in fact no single magic number that best reflects an entity's use of leasing and rental, nor is there an approach to lease accounting that is superior to the existing approach in all circumstances. It is important that EFRAG's advice to the Commission makes clear that the benefits to users from IFRS 16 are, at the very best, as unclear now as they were at the time of EFRAG's comment on the Exposure Draft in 2010.

5. Costs: banking covenants

Of the 36 non-lender respondents, 19 reported that their covenants met these conditions [that the covenants could be impacted by IFRS 16]. However, of those 19 respondents, half expect they will be able to negotiate their covenants upon adoption of IFRS 16." (*EFRAG Feedback Report IFRS 16 Leases: Consultation on the impact on financial covenants in loan agreements. December 2015*)

During the outreach conducted by EFRAG, some lenders have indicated that they do expect to renegotiate covenants on either a contractual or voluntary basis. Some lessees may therefore incur additional costs associated with the renegotiation of their existing financing arrangements. (*EFRAG 2016, Appendix 3, 92*)

EFRAG's consultation on the impact on financial covenants in loan agreements identified a significant mismatch between the views of lenders and borrowers.

The lenders suggested that if lending covenants are breached due to IFRS 16, they will be willing to renegotiate. Borrowers, however, had a different view, with one in four apparently expecting they will *not* be able to renegotiate their covenants.

Particularly given the involvement of the national standard setters of France, Germany, Italy, Lithuania and the UK in this consultation, it does seem likely that these findings can be taken to be reasonably robust. In basing its conclusions on the answers provided by lenders rather than borrowers, there is therefore a risk that EFRAG is not considering the serious concerns of a significant minority of lessees over their banking covenants, a matter that could lead to businesses failing unnecessarily.

We recommend that this key result of EFRAG's valuable research in this area should be included in the advice that will be provided to the Commission.

6. Costs to European businesses

Overall EFRAG believes that the proposals are far from reaching an appropriate cost/benefit trade-off. Significant simplifications are needed, such as exempting numerous small ticket lease arrangements from the requirements of the standard and strengthening the application of materiality when accounting for leases.

(EFRAG letter to IASB, 'Exposure Draft Leases', 14 October 2013)

EFRAG expects that, once users have updated their processes and analyses and trained their staff, users will not incur significant ongoing costs associated with the new standard. *(EFRAG 2016, 117)*

Although the IASB simplified the standard after 2013, most of the complexity remains. For today's operating leases, there will be a very significant extra burden for many lessees, particularly those with large numbers of small leases.

The up-front cost is likely to be very significant but so are the ongoing costs of maintaining detailed central registers for equipment that is typically managed by local operating units. The costs of creating such registers for lessees, and for lessors to create systems to report summary data to lessees, will be particularly high if there is insufficient time allowed between IFRS 16 being adopted for use in Europe and implementation.

There is no evidence to support the notion that this extra bureaucracy could benefit lessees, as is suggested by in the Consultation paragraphs 124 to 128. Obviously if that was the case, lessees would have already chosen to do it.

Possibly the greatest burden on large companies is not the ongoing administration cost, but rather the time of the executive team in having to understand, forecast and explain lease figures in their accounts.

For every simplification made by the IASB, and there have been several since 2013, there are now extra disclosures covering the same ground, which nullifies the benefits and further increases the size and complexity of annual reports. The reality is that little has changed since 2013. EFRAG's conclusion then that there is not an appropriate cost/benefit trade-off remains valid and it should be a key part of EFRAG's advice to the Commission.

Other costs and benefits

The most significant impacts of IFRS 16 could be indirect (effects that depend on the actions of other bodies, such as national accounting standard setters). We are concerned that EFRAG is considering only direct impacts (effects that will follow automatically from the new accounting, such as changes to accounting ratios for

existing IFRS-users). This will not lead to an accurate assessment of the European public good. Examples of the factors that would be missed include:

- The effects if national standards-setters decide to extend the Right of Use model to non-IFRS users through local standards (i.e. the >99% of European companies including most SMEs that are not PIEs). The IASB is clear in its Effects Analysis that it has not considered this as it will be for national standard setters to do. This misses the fact that once a radically different model is in place for the largest companies in Europe, there will inevitably be an argument that a similar approach is needed for other companies to achieve consistency. It seems a classic example of the need to “think small first” set out in the Small Business Act for Europe.
- In many countries, the corporate tax rules follow the accounting rules and it is difficult to see how tax authorities will deal with this. They might require IFRS users to maintain separate IAS17-based accounts for tax purposes; they could have two sets of tax rules, one for IFRS 16 users and the other for all other companies; or they could separate tax rules from accounting. Each of the options could have significant impacts on companies and their investment plans.
- There could be major impacts on European VAT law where Court judgements have relied on IAS 17 definitions. There is already complexity and uncertainty over the VAT treatment of different types of leases. Analysis is needed of how the system would cope with the new model, how soon the necessary changes to legislation could be in place, and what the impacts could be if companies start using IFRS 16 before the system has been changed.

Finally, it seems important to consider whether IFRS 16 is a good fit with other EC initiatives including:

- Investment Plan for Europe
- The sharing economy
- The circular economy
- Promoting green investment including green cars
- Promoting the European automotive manufacturing industry

Given the importance of leasing to the European economy and its unique role in facilitating investment, anything that could make it more difficult to use is likely to impact each of these initiatives.

What is needed now

Leaseurope considers that a full analysis of the impact of IFRS 16 on the European public good will identify, as a minimum, a need for additional interpretation guidance. This might cover:

- Clarification of the rules on 'substitutability' that are currently very complicated and unclear, and in effect shift the problem to the audit firms who can be expected to interpret them conservatively, leading to significant unnecessary costs for European companies.
- Clarification of the small asset exemption in a way that makes it a more useful way of reducing costs for European companies (for example by changing the exemption guidance from US\$5,000 per asset to €5,000 rental cost per asset per year).
- Clarification of requirements for the very extensive disclosures that will otherwise be very expensive to provide and will add considerable 'clutter' to many annual reports.
- Allowing more time for European lessors and lessees, and their systems providers, to make the complex and expensive systems changes that will be required.

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