European Financial Reporting Advisory Group

EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

Preliminary Consultation Document on the endorsement of IFRS 16 *Leases*

Comments requested by [Date]

Note to Constituents

EFRAG is issuing this Preliminary Consultation Document to assist constituents to participate in the development of its endorsement advice on IFRS 16 *Leases* to the European Commission.

The process that EFRAG is undertaking is as follows:

1 Issue this Preliminary Consultation Document.

2 During the consultation period, EFRAG anticipates that it will:

(a) Seek the views of constituents on both the issues raised in this document and any other issues that they consider relevant to EFRAG's advice on the endorsement of IFRS 16;

(b) Conduct additional research on the impact of IFRS 16 on SMEs;

(c) Conduct additional outreach with users of financial statements; and

(d) Obtain evidence and input from an economic study commissioned by EFRAG (see below).

3 Following this preliminary consultation, EFRAG expects to issue a complete draft endorsement advice for an additional short consultation period early in 2017.

EFRAG has commissioned a study by an economic consultancy as an input to the final endorsement advice to the European Commission. This study is not complete at the time of publication of this Preliminary Consultation Document. When complete this study is expected to provide significant input into EFRAG's analysis of the impact of IFRS 16. Areas where the study will provide greatest input are:

- The impact of IFRS 16 on the behaviour of preparers, investors and lenders and the impact of anticipated behavioural changes on the European economy;
- The impact of IFRS 16 on the leasing industry;
- The impact of IFRS 16 on SMEs;
- Whether IFRS 16 is likely to endanger financial stability in Europe; and
- The costs and benefits of endorsing IFRS 16.

Although additional work will be conducted during this consultation, EFRAG nonetheless encourages constituents to provide views on any matters that may be relevant to its endorsement advice. Some specific matters on which EFRAG is seeking input are highlighted in questions set out within this Preliminary Consultation Document.

The following information is provided to supplement this Preliminary Consultation Document:

- The European Commission's request for advice on the endorsement of IFRS 16
- EFRAG Secretariat papers providing additional background to some of the issues covered in this paper – these are identified at relevant points in the Consultation Document.

List of questions to constituents

QUESTIONS ATTACHED TO SPECIFIC SECTIONS

	Question	After para
	Appendix 1	
1	Do you have any information or evidence on the extent to which leases (that you are party to or otherwise aware of) will be eligible for each of the exceptions identified above? If so, please provide details. If you are a preparer, do you expect to use the exceptions? If so, please: (i) quantify the number and annual lease payments for each category; (ii) indicate the proportion of your leases (by volume and/or value) you estimate to be covered by each of the exceptions.	24
2	Which approach to transition do you expect to take? Please explain your reasons for this decision.	39
	Appendix 2	
3	Are you aware of: (i) any contracts that you consider to be leases that would not be classified as leases under IFRS 16; or (ii) any contracts that you consider to be service contracts (or other non-lease contracts) that would be classified as leases under IFRS 16? If so, please provide details of these contracts.	16
4	EFRAG is interested in understanding whether leases of intangible assets (other than rights held by a lessee under licensing agreements within the scope of IAS 38) are common. Do you have any information or evidence as to how frequently such leases of intangible assets arise in practice? If so, please provide information about the types of intangible assets that are subject to leases and the significance in operating and monetary terms.	26
	Appendix 3	
5	Do you have any comments on the comparison of IFRS 16 with IAS 17?	18
6	Do you have any views or information on how IFRS 16 can be expected to affect the behaviour of investors and/or lenders? If so, do you have any views or information on whether and how IFRS 16 could, for European companies that apply IFRS, positively or negatively affect: (i) the overall cost of capital; (ii) access to finance and cost of credit? Please provide any available evidence.	34

	Question	After para
7	Do you have a views or information on how IFRS 16 might affect companies' use of leasing? For example, do you expect lessees to: (i) reduce their use of leases with a corresponding increase in purchases of assets; (ii) reduce their use of leases without a corresponding increase in purchases of assets; (iii) seek to change the terms of new of existing leases to reduce the accounting impact? Please provide any available evidence.	40
8	Do you have any information or views on how the endorsement of IFRS 16 can be expected to affect the leasing industry in Europe? Please provide any available evidence.	42
9	Do you have any information or views on whether IFRS 16 is likely to endanger financial stability in Europe? Please provide any available evidence.	47
10	Do you have any evidence as to the relative costs of applying IFRS 16 and US GAAP? Do you have any other views as to the advantages or disadvantages of IFRS 16 compared to US GAAP?	64
11	What is your view on the one-off and ongoing costs for preparers? Will preparers that already report finance leases have lower costs than preparers without finance leases? Please provide any evidence you have on the expected magnitude of the costs.	113
12	Are you aware of any costs for users in additional to those identified above? Please quantify if possible.	116
13	If a lessee has to develop new systems to support the accounting for leases, to what extent do you expect internal benefits from the information provided by the new information? Please quantify to the extent possible. Do you agree with the benefits for users and preparers identified above? Are there any additional benefits for users and preparers? Please provide evidence where available.	126
	GENERAL QUESTIONS	
14	EFRAG has heard that IFRS 16 may have an impact on the regulatory position of financial institutions. Do you have any evidence of any likely impact?	
15	EFRAG has not considered interactions with regulations within the specific competence of Member States, such as income tax. Do you have any evidence of such impacts and how individual Member States are addressing such impacts?	
16	EFRAG has not identified any evidence that suggests that IFRS 16 will contribute to tax fraud or tax avoidance. Are you aware of any such evidence?	
17	Are there any issues that have not been raised in this Preliminary Consultation Document that should be considered by EFRAG? Please explain your view.	

Contents

Appendix 1: Summary of IFRS 16 *Leases*

Why is the IASB changing lease accounting?

1 Prior to the issuance of IFRS 16 *Leases,* IAS 17 *Leases* applied. Under IAS 17, leases were classified as either finance leases (substantially all the risks and rewards incidental to ownership of an asset are transferred from lessor to lessee) or operating leases (all leases other than finance leases). IAS 17 requires lessees to recognise assets and liabilities arising under finance leases and not to recognise assets and liabilities arising under operating leases.

2 The IASB initiated a project to improve the financial reporting of leasing activities to respond to criticisms from users of financial statements that the accounting model for leases failed to meet their needs. The criticisms included the following:

(e) Information reported by lessees about operating leases lacked transparency by failing to recognise that these transactions give rise to assets and liabilities. As a result, many users adjusted a lessee's financial statements by estimating how operating leases should be capitalised in order to reflect the financing and assets provided by leases.

(f) The existence of two different lessee accounting models meant that transactions that were economically similar could be accounted for very differently, thus reducing comparability for users of the financial statements.

(g) Users had inadequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the underlying asset), particularly for leases of equipment and vehicles that were classified as operating leases.

How have the issues been addressed?

3 In order to address the above criticisms, the IASB issued IFRS 16 with the objective of ensuring that lessees and lessors provide relevant information in a manner that faithfully represents lease transactions.

4 For lessees, IFRS 16 introduces a single lessee accounting model. This new accounting model eliminates the classification of leases as either finance or operating and requires lessees to recognise assets and liabilities for the rights and obligations created by leases.

5 Unlike IAS 17, which focuses on identifying when leasing an asset is economically similar to purchasing that asset, IFRS 16 reflects the fact that, at the start of a lease, a lessee obtains the right to use an asset for a period of time and incurs a liability to make future lease payments. Consequently, a lessee recognises a right-of-use asset and a lease liability for all leases, with two exceptions (see paragraph 24).

6 For lessors, the IASB concluded that lessor accounting under IAS 17 was well understood. As a result, IFRS 16 carries forward substantially all of the lessor accounting requirements in IAS 17. However, to address the criticism that lessors did not provide adequate information about their exposure to certain risks, IFRS 16 requires enhanced disclosures of information about a lessor's leasing activities.

7 IFRS 16 was issued on 13 January 2016. It supersedes IAS 17 and associated interpretations (IFRIC 4 *Determining whether an Arrangement contains a Lease,* SIC-15 *Operating Leases–Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*)[1]. IFRS 16 has been designed to complement IFRS 15 *Revenue from Contracts with Customers.* This intended

[1] References to IAS 17 throughout this document include reference to these associated Interpretations,

complementarity is evident in a number of places including the accounting requirements in IFRS 16 on sale and leaseback transactions and the prohibition on early application of IFRS 16 unless IFRS 15 is also applied.

What has changed?

8 The most important change compared to IAS 17 is that IFRS 16 requires lessees to account for all leases in a similar way by requiring the recognition of lease assets (a right-of-use asset) and lease liabilities (a financial liability). The right-of-use asset represents a lessee's right to use the asset which is the subject of a lease for the duration of the lease term.

9 IFRS 16 substantially retains the lessor accounting from IAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently.

10 This Section addresses the following major areas of change:

(a) General features:

(i) Scope – intangible assets;

(ii) Identification of a lease;

(iii) Separating components of a contract;

(iv) Lease modifications;

(b) Lease accounting by lessees;

(c) Lease accounting by lessors;

(d) Specific transactions:

(i) Sale and leaseback;

(ii) Subleases; and

(e) Presentation and disclosure.

General features

Scope – intangible assets

11 IAS 17 excluded licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights from its scope and applied to all other leases (including leases of intangible assets). IFRS 16 also excludes the identified licensing agreements from its scope. However, it permits entities not to apply IFRS 16 to leases of other intangible assets.

Identification of a lease

12 The definitions of a lease in IAS 17 and IFRS 16 are similar, with IFRS 16 defining a lease as a contract that conveys the right to use an asset for a period of time in exchange for consideration. However, IFRS 16 introduces new and more detailed guidance on identifying a lease. Under IFRS 16, a contract is (or contains) a lease only when all of the following three conditions are met:

(a) *There is an identified asset.* An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer. Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has a substantive right to substitute the asset throughout the period of use. A substantive substitution right exists if the supplier has the practical ability to substitute the asset and would benefit economically from exercising its substitution right. A legal right to substitute is not, in itself, conclusive. If the customer is unable to reach a conclusion on whether a substitution right is substantive, there is a presumption that any substitution right is not substantive.

(b) In order to control the use of the identified asset, the customer must have the *right to obtain substantially all of the economic benefits from use* of the asset throughout the period of use.

(c) The customer has the *right to direct the use* of the identified asset throughout the period of use. This requires assessing which party has the right to direct how and for what purpose the asset is used. If those decisions are predetermined, the customer assesses whether it has the right to operate (or direct others to operate) the asset, or whether it has designed the asset in a way that predetermines how and for what purpose it is used. A supplier's protective rights, in isolation, do not prevent the customer from having the right to direct the use of the asset.

<u>Separating components of a contract</u>

13 Both IFRS 16 and IAS 17 require the separation of contracts between the lease and any non-lease components.

14 For lessees, both standards require that the components are separated by allocating the consideration in the contract to each lease component based on relative stand-alone prices and to non-lease components based on their aggregate stand-alone prices. If an observable stand-alone price is not readily available, the lessee estimates the stand-alone price by maximising the use of observable information. As a practical expedient, IFRS 16 provides the option, by class of underlying asset, not to separate lease components from non-lease components and instead account for them as a single lease.

15 For lessors, under IFRS 16, the consideration received is allocated to lease and non-lease components by applying IFRS 15.

<u>Lease modifications</u>

16 Unlike IAS 17, IFRS 16 contains guidance for both lessee and lessor on modifications to leases. For lessees and lessor finance leases, a lease modification is accounted for as a separate lease if the modification increases the scope of the lease by adding the right to use one or more underlying assets and the consideration is commensurate with the stand-alone price for the increase in scope.

17 For the above lease modifications that are not accounted for as a separate lease, a lessee accounts for the modification by remeasuring the lease liability. The lessee adjusts the carrying amount of the right-of-use asset and, for a decrease in the scope of a lease, recognises any gain or loss in profit or loss.

18 For lessor operating leases, a modification is recognised as a new lease.

Lease accounting by lessees

19 Similar to finance lease accounting under IAS 17, IFRS 16 requires the lease liability to be measured initially on the basis of the present value of future lease payments. However, IFRS 16 provides more detailed guidance than IAS 17. The lease payments included in the measurement comprise:

(a) fixed lease payments (including in-substance fixed payments) less any lease incentives receivable;

(b) variable lease payments that are based on an index or a rate, using the index or rate as at the commencement date;

(c) amounts expected to be payable under residual value guarantees; and

(d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option and payments of penalties to terminate the lease if the lease term reflects early termination.

20 The payments are discounted using the interest rate implicit in the lease, or the lessee's incremental borrowing rate where the interest rate implicit in the lease cannot be readily determined.

21 Lease liabilities are subsequently measured similarly to financial liabilities at amortised cost. When relevant, the lease liability is remeasured, with corresponding adjustments to the right-of-use asset, to reflect changes to:

(a) the lease term;

(b) the assessment of a purchase option;

(c) the lease payments resulting from a change in floating interest rates; and

(d) the amounts expected to be payable under residual value guarantees or future lease payments resulting from a change in an index or a rate used to determine those payments.

22 The right-of-use asset is initially measured at the amount of the initial lease liability plus any initial direct costs, such as commissions and legal fees incurred by the lessee. Adjustments may also be required for lease incentives received, payments made at or prior to the commencement date and any restoration obligations.

23 The right-of-use asset is subsequently measured similarly to other non-financial assets (such as property, plant and equipment), at cost less accumulated depreciation and accumulated impairment. A lessee may apply an alternative measurement basis in accordance with the relevant standard when the right-of-use asset is an investment property and the lessee measures its other investment properties at fair value, or when the lessee applies the revaluation model to the class of property, plant and equipment to which the right-of-use asset belongs.

24 IFRS 16 permits lessees not to recognise assets and liabilities arising under:

(a) short-term leases (leases for 12 months or less) where the election is made by class of underlying asset; and

(b) leases for which the underlying asset is of low value based on the value when the asset was new, where the election is made on a lease-by-lease basis.

Question for constituents

Do you have any information or evidence on the extent to which leases (that you are party to or otherwise aware of) will be eligible for each of the exceptions identified above? If so, please provide details.

If you are a preparer, do you expect to use the exceptions? If so, please:

(i) quantify the number and annual lease payments for each category;

(ii) indicate the proportion of your leases (by volume and/or value) you estimate to be covered by each of the exceptions.

Lease accounting by lessors

25 IFRS 16 substantially carries forward lessor accounting from IAS 17. One major difference is that the initial measurement of the lease payments included in the measurement of the net investment in a finance lease includes those variable lease payments that depend on an index or rate and payments that appear to be variable but are in-substance fixed. Other variable lease payments, such as payments based on revenue or usage, are recognised in profit or loss in the period during which the event or condition that triggers those payments occurs.

Specific transactions

<u>Sale and leaseback</u>

26 A sale and leaseback transaction involves the seller-lessee transferring an underlying asset to the buyer-lessor, followed by the seller-lessee leasing that asset back from the buyer-lessor. IFRS 16 requires an entity to determine whether the transfer of the underlying asset is a sale by considering when a performance obligation is satisfied in accordance with IFRS 15.

27 When, within the context of a sale and leaseback transaction, a sale has taken place, IFRS 16 requires the seller-lessee to derecognise the underlying asset and apply the lessee accounting model to the leaseback. At the same time, the buyer-lessor recognises the underlying asset and applies the lessor accounting model to the leaseback. The lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount that relates to the right-of-use retained by the seller-lessee and recognises a gain or loss that is limited to the rights transferred to the buyer-lessor.

28 When the transfer of the asset between the lessee and the lessor does not satisfy the requirements of IFRS 15 for a sale, both lessee and lessor account for their rights and obligations arising from the transaction as financial assets and financial liabilities in accordance with IFRS 9 *Financial Instruments*.

<u>Subleases</u>

29 Unlike IAS 17, IFRS 16 contains explicit guidance on how to account for subleases. IFRS 16 requires an intermediate lessor to account for a head lease and a sublease as two separate contracts, applying both lessee and lessor accounting. When classifying a sublease, an intermediate lessor evaluates the lease as a finance lease or an operating lease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset.

Presentation and disclosure

30 IFRS 16 provides an overall disclosure objective which applies to both lessees and lessors. IFRS 16 requires an entity to '*disclose information in the notes that, together with information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows*'.

31 For lessees, unlike IAS 17, IFRS 16 contains detailed presentation and disclosure requirements, including requiring information about leases to be provided in a single note or a separate section in the financial statements. In particular, IFRS 16 requires:

(a) Separate presentation of the right-of-use asset and lease liabilities either in the statement of financial position or in the notes.

(b) Information relating to revenues and expenses including depreciation and impairment of right-of-use assets by class of underlying asset, interest expense on lease liabilities, expenses relating to short-term leases and leases of low-value assets, expenses for variable lease payments not included in lease liabilities and income from sub-leasing right-of-use assets.

(c) Information relating to the statement of cash flows including the total cash outflow for leases, cash payments for the principal portion of the lease liability and cash payments for the interest portion of the lease liability. The cash payments for the principle portion of the lease liability are presented within financing activities and, for the interest portion, as either operating or financing activities. Payments for short-term leases and leases of low-value assets not included in the measurement of the lease liability are presented within operating activities.

(d) Any additional entity-specific information that is relevant to satisfying the disclosure objective, for example information about extension options and termination options, variable lease payments and sale and leaseback transactions.

32 Disclosure requirements for lessors that are additional to those in IAS 17 include information about leasing activities including how the lessor manages the risks associated with the rights that it retains in underlying assets.

When does IFRS 16 become effective?

33 An entity shall apply IFRS 16 for annual periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply IFRS 15 at or before the date of initial application of IFRS 16.

Transition requirements

Lessees

34 A lessee applies IFRS 16 using one of the following methods:

(a) retrospectively to each prior reporting period presented in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or

(b) retrospectively, with the cumulative effect of initially applying IFRS 16 recognised at the beginning of the financial reporting period in which the entity first applies the Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate). Comparative information is not restated.

Lessors

35 Because IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17, in most cases a lessor is not required to make any adjustments on transition. However, an intermediate lessor in a sublease agreement is required to reassess each sublease that was previously classified as an operating lease to determine whether it should be classified as an operating lease or a finance lease under IFRS 16.

Practical expedients

36 As a practical expedient, lessees and lessors are not required to reassess whether an existing contract is, or contains, a lease at the date of initial application of IFRS 16. An entity that applies the practical expedient only applies the IFRS 16 definition of a lease to assess whether contracts entered into (or changed) on or after the date of initial application are, or contain, leases.

37 IFRS 16 also provides an extensive range of practical expedients on transition for lessees, most significantly in relation to leases that were classified as operating leases under IAS 17.

Sale and leaseback transactions

38 An entity shall not reassess sale and leaseback transactions entered into before the date of initial application of IFRS 16 in order to determine whether the transfer of the underlying asset constitutes a sale under IFRS 15.

39 If a sale and leaseback transaction was accounted for as a sale and a finance lease under IAS 17, the seller-lessee shall continue to amortise any gain on sale over the lease term and account for the leaseback in the same way as it accounts for any other finance lease existing at the date of initial application.

Question for constituents

Which approach to transition do you expect to take? Please explain your reasons for this decision.

Appendix 2: EFRAG's technical assessment of IFRS 16 against the endorsement criteria

Notes to Constituents:

This Appendix sets out the basis for the technical conclusions reached by EFRAG on IFRS 16 *Leases*. In it, EFRAG assesses how IFRS 16 satisfies the technical criteria set out in the Regulation (EC) No 1606/2002 for the endorsement 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 IFRS 16 leads to prudent accounting, and finally considers whether IFRS 16 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 any difference is that EFRAG's thinking may evolve during the development of the final IFRS or interpretation.

Summary

1 This Appendix contains EFRAG's assessment of IFRS 16 *Leases* against the technical endorsement criteria. In summary, EFRAG's overall assessment is that IFRS 16 meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management, and leads to prudent accounting.

2 EFRAG has identified areas in which limitations exist to relevance and reliability (in relation to the scope and recognition exceptions) and to comparability (in relation to the transition requirements and to the scope and recognition exemptions). However none of the limitations identified impedes IFRS 16 from meeting each of the criteria and from delivering prudent accounting.

3 EFRAG assesses that IFRS 16 is not contrary to the true and fair view principle, in that it:

- (a) meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management, and leads to prudent accounting;
- (b) does not create any negative interactions with other IFRS (it is specifically designed to complement IFRS 15 *Revenue from Contracts with Customers*) and does not lead to unavoidable distortions or significant omissions of information that would be contrary to the true and fair view principle; and
- (c) requires appropriate disclosures that provide a complete and reliable depiction of an entity's assets, liabilities, financial position, profit or loss and cash flows.

4 As a result, EFRAG concludes that IFRS 16 meets the technical criteria for endorsement.

Does the accounting that results from the application of IFRS 16 meet the technical criteria for endorsement in the European Union?

5 EFRAG has considered whether IFRS 16 meets 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 IFRS 16:

(a) is not contrary to the principle set out in Article 4(3) of Council Directive 2013/34/EU (the Accounting Directive); and

(b) meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

6 Article 4(3) of the Accounting Directive provides that:

7 *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.*

8 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).

9 EFRAG's assessment as to whether IFRS 16 would not be contrary to the true and fair view principle has been performed against the European legal background summarised above. In its assessment, EFRAG has considered IFRS 16 from the perspectives of both usefulness for decision-making and assessment of the stewardship of management. As explained in paragraphs 210-214, EFRAG has concluded that the information resulting from the application of IFRS 16 is appropriate both for making decisions and assessing the stewardship of management.

Question to the EFRAG Board

One EFRAG Board member proposes that paragraph 9 should be amended as marked-up below. The proposed change would result in different wording to that which has been used in previous Endorsement Advices and would place much greater emphasis on specific provisions of the Accounting Directive. Do other EFRAG Board members support making this change?

Further, this EFRAG Board member has suggested additional reference to the Accounting Directive in several other places in the Preliminary Consultation Document. These are marked-up for the consideration of the EFRAG Board.

EFRAG's assessment as to whether IFRS 16 would not be contrary to the true and fair view principle has been performed has been performed in the light of the Accounting Directive ~~against the European legal background summarised above~~. The Accounting Directive does not address specifically the topic of leases and/or the definition of a right-of-use and therefore neither encourages nor prohibits explicitly the recognition of leases as assets (directly or via right-of-use) and liabilities. However, the Accounting Directive, in Recital 16 states that "the presentation of items in financial statements should have regard to the economic reality or commercial substance of the underlying transaction or arrangement" and echoed in Article 6.1(h). In this context, the European Union has endorsed IAS 17 which recognises financial leases as assets and liabilities. In most European jurisdictions, following the transposition of the Directive, leases are not recognised as assets and liabilities except for financial leases in non-IFRS consolidated financial statements and in statutory financial statements for which such a recognition is optional or mandatory.

In its assessment, EFRAG has considered IFRS 16 from the perspectives of both usefulness for decision-making and assessment of the stewardship of management. ~~As explained in paragraphs 193-197, EFRAG has concluded that the information resulting from the application of IFRS 16 is appropriate both for making decisions and assessing the stewardship of management.~~

10 EFRAG's assessment on whether IFRS 16 is not contrary to the true and fair view principle set out in Article 4(3) of the Accounting Directive is based on the assessment of whether it meets all other technical criteria and whether it leads to prudent accounting. EFRAG's assessment also includes assessing whether IFRS 16 does 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 14–88;

(b) reliability: paragraphs 89–125;

(c) comparability: paragraphs 126–165;

(d) understandability: paragraphs 166–185;

(e) whether overall IFRS 16 leads to prudent accounting: paragraphs 186–209; and

(f) whether IFRS 16 would lead to financial reporting that is not contrary to the true and fair view principle: paragraphs 210–214.

11 In providing its assessment on whether IFRS 16 results in relevant, reliable, understandable and comparable information and leads to prudent accounting, EFRAG has considered all the requirements of IFRS 16. EFRAG has, however, focused its assessment on the requirements it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on provisions in IFRS 16 that:

(a) are fundamental to the accounting for leases;

(b) have been the subject of substantial debate (as evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests of the two Exposure Drafts and the Standard);

(c) may be problematic to apply as evidenced by the results of EFRAG's field-tests; or

(d) relate to issues raised by the European Commission in its request for endorsement advice dated 9 June 2016.

12 The focus of the technical assessment is on accounting by lessees, as that is the area in which IFRS 16 makes significant changes. As noted in Appendix 1, the accounting by lessors is substantially unchanged.

13 EFRAG has identified four areas where IFRS 16 has changed lessor accounting that warrant assessment of the impact on relevance and reliability. These are:

(a) The asymmetry between lessee and lessor accounting;

(b) The inclusion of variable lease payments based on index or rate in the initial measurement of finance leases;

(c) sublease arrangements; and

(d) the disclosure requirements introduced by IFRS 16.

Relevance

14 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.

15 EFRAG considered whether IFRS 16 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. In its assessment of relevance, EFRAG has identified the following topics as being the most significant to this assessment based on the criteria in paragraph 11:

(a) Definition of a lease

(b) Identification of a lease

(c) Lessee accounting

    (i) Recognition of a right-of-use asset and a lease liability

    (ii) Initial measurement of the right-of-use asset and the lease liability

    (iii) Subsequent measurement of the right-of-use asset and the lease liability

    (iv) Lease modifications

    (v) Sale and leaseback transactions

    (vi) Presentation

    (vii) Disclosures

    (viii) Transition requirements

(d) Lessor accounting

    (i) Sublease arrangements

    (ii) Disclosures.

Definition of a lease

16 During the development of IFRS 16, concerns were raised that the definition of a leases might incorrectly scope services into the definition of a lease or exclude contracts that are leases from the scope of the Standard. The definitions of a lease in IFRS 16 and IAS 17 are similar, and EFRAG is not aware of any contracts that would be inappropriately classified, given the similarities in the definitions.

Question to constituents

Are you aware of:

(i) any contracts that you consider to be leases that would not be classified as leases under IFRS 16; or

(ii) any contracts that you consider to be service contracts (or other non-lease contracts) that would be classified as leases under IFRS 16?

If so, please provide details of these contracts.

Identification of a lease

~~16~~17 As noted in Appendix 1, IFRS 16 states that a contract is, or contains, a lease, when all of the following three conditions are met:

(a) there is an identified asset;

(b) the customer has the right to obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use; and

(c) the customer has the right to direct the use of the identified asset throughout the period of use.

~~17~~18 These conditions are similar to those in IFRIC 4 *Determining whether an Arrangement contains a Lease*, which were assessed to result in relevant information in EFRAG's 2004 endorsement advice. However, IFRS 16 includes additional guidance on assessing whether a contract conveys the right to control an underlying asset (which is the case when the conditions in paragraphs 17(b) and (c) above are met). Further, the general approach in IFRS 16 to the concept of control is consistent with the approach taken in IFRS 10 *Consolidated Financial Statements* and IFRS 15.

~~18~~19 Each of these conditions is necessary, but not sufficient in isolation, to identify whether a contract conveys the right to control the use of an asset for a period of time. Some of the characteristics of these conditions are highlighted below.

(a) 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 the asset. The reasoning is that the customer cannot be considered to control an asset if the supplier is able to substitute the asset throughout the lease term. A second implication, which the IASB has explicitly indicated, is that a portion of capacity that is not physically distinct cannot be an identified asset unless it represents substantially all of the capacity of the underlying asset. EFRAG agrees that control over a portion of an asset depends on the ability to physically segregate that portion – for instance, a lessee of a portion that cannot be segregated would be unable to unilaterally decide when its portion of capacity is used or where its portion of output is produced.

(b) The entitlement to the economic benefits arising from the use differentiates between a lessee that has control over an underlying asset and an agent that acts on behalf of others.

(c) The right to direct the use of the identified asset occurs when control has passed from the supplier to the customer. That is, this criterion excludes contracts from the scope of IFRS 16 where the customer has only a right to future performance, but not a current ability to control a resource. This right to direct the use does not need to be absolute and a lessee can still have the right to direct the use even though the agreement includes limitations on the use of the identified asset such as protective rights. In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service.

~~19~~20 The correct identification of contracts that are, or that contain, a lease is particularly important for lessees because it triggers the recognition of assets and liabilities. Clear guidance on the identification of a lease contributes to the relevance of information because it excludes from recognition those contracts that do not give control of an asset to a customer. In EFRAG's view, items should not be recognised by an entity as assets unless they are controlled by that entity.

~~20~~21 EFRAG acknowledges that, in certain cases, judgement will be required to assess if the customer has obtained control over an identified asset. Such judgements are not dissimilar from those required by other IFRS Standards and the limited outreach conducted by EFRAG has not identified that the judgement required in this area is more complex than judgements required by other IFRS Standards. EFRAG notes that the articulation of the principles in IFRS 16 Appendix B *Application Guidance* will assist in the exercise of judgement.

Lessee accounting

Recognition of a right-of-use asset and a lease liability

22 The recognition of assets and liabilities for operating leases is the key evolution introduced by IFRS 16. Even if the current treatment of operating leases is and remains compatible with (i) the Accounting Directive, (ii) the legal contractual translation of lease contracts and (iii) other implications of such contracts (for instance in terms of taxation, bankruptcy), the new treatment introduced puts the emphasis, for those financial statements prepared under IFRS, on "the economic reality and commercial substance of the underlying transaction or arrangement" (Article 6.1(h) and Recital 16). The key element of the "substance" of all leases (including those designated as operating leases under IAS 17) is the right to control the use of the underlying asset, even if other features exist. EFRAG assesses that for those financial statements such an emphasis is appropriate. [Proposal by EFRAG Board member]

~~21~~23 In particular, ~~A key reason for issuing IFRS 16 is that~~ users have indicated that, in their view, lease contracts create assets and liabilities that should be recognised by lessees. Further, academic studies have shown that information on the face of the financial statements is more relevant than disclosures in the notes[2]. It follows that the requirement in IFRS 16 for a lessee to recognise right-of-use assets and lease liabilities arising under lease contracts (as distinct from note disclosure or cash flow disclosures as is required under IAS 17) is critical to the provision of relevant information. EFRAG notes that the recognition of a right-of-use asset will eliminate the distinction in the presentation between an acquired asset and a leased one, especially when the right-of-use asset is not presented separately from other assets. In that case however, the standard requires additional disclosures. Finally, EFRAG assesses that the standard provides relevant information on leases as well as on the flexibility that they enable in comparison with acquisitions. [Proposal by EFRAG Board member]

~~22~~24 IFRS 16 defines a lease on the basis of criteria that identify only those situations in which a lessee has obtained control over a resource. The requirement for a lessee to recognise a right-of-use asset and a lease liability provides relevant information because information about the nature and amounts of the different economic resources available to the lessee and claims against those resources can help users to identify an entity's financial strengths and weaknesses. That is, recognition of an asset over which the entity has obtained control has predictive value in that it assists users to assess the entity's ability to generate future cash inflows through the use of the underlying assets and enhances transparency about the capital employed. Recognition of a lease liability provides information about obligations to make future cash outflows and, hence, enhances transparency about an entity's financial leverage.

SCOPE EXCEPTIONS – LEASES OF INTANGIBLE ASSETS

~~23~~25 Intangible assets are outside the scope of IFRS 16 if they are rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. This scope exception could reduce the relevance of information provided by applying IFRS 16 by omitting from the financial statements certain assets controlled by an entity and the associated liabilities. EFRAG acknowledges that there is no conceptual reason to exclude these contracts, because the lack of physical substance does not prevent a lessee from obtaining control of an underlying asset.

2 See EFRAG and ICAS 2013 Academic literature review: *The use of information by capital providers.*

~~24~~26 An entity is permitted, but not required, to apply IFRS 16 to intangible assets (other than the ones referred to in paragraph 25 above). EFRAG has no evidence as to whether leases of such intangible assets are frequent, and therefore EFRAG has no evidence that the scope exemption in IFRS 16 will result in a significant loss of information.

Question to constituents

EFRAG is interested in understanding whether leases of intangible assets (other than rights held by a lessee under licensing agreements within the scope of IAS 38) are common. Do you have any information or evidence as to how frequently such leases of intangible assets arise in practice? If so, please provide information about the types of intangible assets that are subject to leases and the significance in operating and monetary terms.

~~25~~27 EFRAG therefore concludes that any requirement for lessees to apply IFRS 16 to leases of intangible assets (other than the ones referred to in paragraph 25 above) would affect an unknown population of contracts. The benefits of such a requirement may not justify the cost of applying IFRS 16. Finally, EFRAG notes that entities applying IAS 17 and already recognising assets and liabilities for such leases will not be prevented from continuing to do so.

SEPARATING COMPONENTS OF A CONTRACT

~~26~~28 EFRAG considers that separating lease and non-lease components in a contract provides relevant information to users because leases create assets and liabilities for a lessee (by virtue of the lessor's performance at lease commencement the lessee obtains the right to use the underlying asset and has an obligation to pay for that right) while service components that require continued performance by the lessor throughout the lease term do not. Consequently, requiring lessees to capitalise service components would result in lessees overstating right-of-use assets and lease liabilities.

~~27~~29 EFRAG has assessed that allocating consideration based on the relative stand-alone prices of lease and non-lease components will provide relevant information in situations where the sum of the stand-alone selling prices equals the total consideration paid or payable under the contract. This is because the allocation would reflect the cost pattern that would have been incurred if the lease and non-lease components had been entered into through separate contracts.

~~28~~30 However, EFRAG assesses that allocating the contracts based on relative stand-alone selling prices has the consequence that:

(a) any discount in the contract is allocated proportionately to the lease and non-lease components regardless of whether the discount relates (entirely or proportionately more) to one or more specific components; and

(b) any amount of consideration that is variable will be allocated in a similar way to all components of the contract.

~~29~~31 This is in contrast to IFRS 15 whereby discounts and variable consideration in the contract are required to be allocated to the relevant performance obligation when certain conditions are met. Thus, IFRS 16 may not always lead to the most relevant information for users, for instance, in situations where the lessee has evidence that a discount was granted for only one component (for instance, if the lease or non-lease components can also be purchased on a stand-alone basis).

~~30~~32 EFRAG has not been able to gather evidence as to the frequency of a discount relating to some components of a contract, rather than relating to the contract as a whole. Further, EFRAG is unable to ascertain whether a lessee would have the necessary information to make an allocation to specific components or whether the additional complexity would outweigh the benefit of this information.

EXEMPTIONS AND PRACTICAL EXPEDIENTS ON RECOGNITION

~~31~~33 EFRAG acknowledges that ~~does not generally support introducing~~ exemptions or practical expedients ~~because they~~ may undermine the relevance of financial information. However, EFRAG also acknowledges that there is a trade-off between any loss of relevance for users with the reductions in complexity and cost that such exemptions and practical expedients give preparers.

~~32~~34 EFRAG considered whether the optional recognition exemptions for short-term leases and leases for which the underlying asset is of low value (low-value assets) and the practical expedient to not separate non-lease components from lease components would result in the omission of relevant information.

~~33~~35 EFRAG first observes that fieldwork conducted by the IASB has suggested that, in most cases, assets and liabilities arising from leases within the scope of the low-value assets exemption would not be material, even in aggregate. In such cases, the effects of the exemption would not be different from applying the concept of materiality in the Conceptual Framework and in IAS 1 *Presentation of Financial Statements*. However, the IASB also acknowledged the risk that the aggregate value of leases captured by the exemption might be material in some cases.

~~34~~36 EFRAG also considered the fact that, when a lessee uses the exemptions for short-term leases and leases of low-value assets, specific disclosures are required under IFRS 16 and in particular:

(a) the lease expenses for short-term leases and leases of low-value assets are disclosed separately; and

(b) the future lease commitments for short-term leases are disclosed if the portfolio of short-term leases at the end of the reporting period is dissimilar to the portfolio over the reporting period.

~~35~~37 EFRAG observes that the above disclosures will enable users to understand some of the effects of use of the exemptions for short-term leases and leases of low-value assets. However, EFRAG notes that no disclosure is required about future lease commitments for leases of low-value assets. Although leases of low-value assets are likely to be immaterial in many cases, the disclosure of the related expense may not mitigate in all circumstances the lack of recognition when leases of low-value assets are significant in aggregate. This may limit the ability of users to understand the impact of this exemption in cases where leases of low-value assets are significant in aggregate.

~~36~~38 EFRAG also observes that no disclosures are specifically required when a lessee uses the accounting policy election not to separate lease and non-lease components contained in a lease contract. Even though IAS 1 requires disclosure of this accounting policy election when it is relevant to understanding the lessee's financial statements, the usefulness of the information may be limited as the relative effects of the lease and non-lease components may not be identifiable.

~~37~~39 Overall, despite the limitations described, EFRAG assesses that the disclosures required by IFRS 16 will generally provide users with sufficient information to understand how the recognition exemptions and practical expedients affect a lessee's financial statements.

Initial measurement of the right-of-use asset and the lease liability

~~38~~40 The lease liability is measured as the present value of the payments for the right to use the underlying asset during the lease term. The lease term encompasses:

(a) periods covered by options to extend the lease if the lessee is reasonably certain to exercise the option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise the option.

41 EFRAG considers that these requirements provide relevant information to users in relation to the period over which the lease will affect the lessee's cash flows. Based on evidence received in its outreach on Exposure Draft ED/2013/6 *Leases* (the 2013 ED), EFRAG understands that the current practice of accounting for lease options that are 'reasonably certain' to be exercised works well in practice for both preparers and users.

~~39~~42 EFRAG observes that IFRS 16 does not introduce new concepts relating to lease term determination and requires to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise an option. IFRS 16 also includes extended illustrative guidance on the types of factors that an entity should consider in making the assessment.

~~40~~43 Some would consider that payments to be made under an extension option are not unavoidable contractual payments (as the lessee retains the discretion to avoid the outflow of resources until the option is exercised) and that a requirement to estimate whether renewal options will be exercised at specific points in the future fails to acknowledge the flexibility provided by leases. However, EFRAG considers that not recognising options that are likely to be exercised could, in some circumstances, distort the depiction of performance of the entity. For example, when the terms are advantageous to the lessee, the value of the option is likely to have been incorporated in the payments for the initial term, which will then be higher relative to the payments for the optional periods. Excluding the payments for the optional periods would result in recognising a higher cost of the lease in the first non-cancellable period which would not result in relevant information.

~~41~~44 Variable lease payments relate to:

(a) payments based on an index or rate, which are included in the measurement of the lease liability; and

(b) payments linked to future performance, which are not included in the measurement of the lease liability.

~~42~~45 EFRAG assesses that including in the measurement of lease liabilities variable lease payments that are based on an index or rate using the index or rate at the commencement date (i.e. excluding estimates of the effects of future changes in indexes or rates) provides relevant information. These payments represent the lessee's unavoidable obligation based on conditions at the applicable date.

~~43~~46 Variable lease payments that are linked to future performance or use of an underlying asset are not included in the initial measurement of the lease liability. EFRAG has considered whether this requirement would result in the omission of relevant information, taking into account the predictability of the cash outflows. EFRAG observes that it may be difficult to accurately estimate these variable lease payments (i.e. that there is a high level of measurement uncertainty).

47 Some might consider that a comparable level of uncertainty exists in assessing whether renewal or termination options will be exercised, and under IFRS 16 this does not prevent such options from being considered when they are 'reasonably certain' to be exercised (see paragraphs 40 and following). EFRAG considers that there is a higher level of measurement uncertainty in assessing variable lease payments based on usage or performance as the assessment depends on the future activity of the lessee and may require consideration of a range of possible outcomes and their probabilities. ~~In contrast, estimating whether the exercise of an option is reasonably certain is a binary assessment~~

48 ~~.~~ EFRAG retains the view in its comment letter to the IASB on the 2013 ED that the usefulness of information is decreased when it is subject to frequent reversals and

adjustments as a result of changes in estimates and, as a consequence, there is a trade-off to consider between the relevance and the reliability of the information.

49 On that basis, ~~As a result,~~ EFRAG assesses that these requirements of IFRS 16 would generally provide relevant information. However, EFRAG also acknowledges there might be situations whereby a lessee can predict with 'reasonable certainty' the level of usage or performance of a leased asset and under such circumstances the exclusion of variable payments might decrease the relevance of information.

~~44~~50 Finally, EFRAG observes that additional disclosures are required for payments that are not included the measurement of the lease liability, in particular:

(a) the expense for the period relating to variable lease payments not included in the measurement of lease liabilities; and

(b) the future cash outflows to which the lessee is potentially exposed that have not been reflected in the measurement of lease liabilities (when required to meet the disclosure objective).

~~45~~51 EFRAG assesses that these disclosures will provide useful information to users about the effect of variable lease payments.

Subsequent measurement of the right-of-use asset and the lease liability

~~46~~52 The subsequent measurement of the right-of-use asset is at cost less accumulated depreciation and accumulated impairment losses, adjusted for remeasurements of the lease liability. EFRAG considers that this reflects the consumption of the economic benefits from the right-of-use asset by the lessee and is similar to the subsequent measurement of assets of a similar underlying nature such as property, plant and equipment. EFRAG assesses that this provides relevant information which has confirmatory value as it provides information about the economic resources available to generate future cash inflows.

~~47~~53 Subsequent measurement of the lease liability is on an amortised cost basis, subject to the lease modifications discussed in paragraphs 59–60, below. EFRAG assesses that this provides information which is useful for predicting future cash outflows as it reflects the lessee's obligation to pay the amounts specified in the contract.

~~48~~54 EFRAG acknowledges that, in principle, users of financial statements receive more relevant information if lessees reassess the use of extension, termination and purchase options on a regular basis. This is because the reassessment would reflect current economic conditions. However, EFRAG also acknowledges that requiring reassessment at each reporting date would be costly for an entity with many leases that include options.

~~49~~55 EFRAG considers that an appropriate balance has been achieved between relevance and cost and complexity by requiring reassessment only upon the occurrence of a significant event or change in circumstances, that is within the control of the lessee, affecting whether the lessee is reasonably certain to exercise, or not to exercise, an option to extend a lease, to terminate a lease or to purchase an underlying asset.

Other measurement models for the right-of-use asset

~~50~~56 IFRS 16 requires a right-of-use asset that meets the definition of an investment property to be measured on the same basis as owned investment properties under IAS 40 *Investment Property*.

~~51~~57 EFRAG assesses that measuring investment properties and right-of-use assets that are investment properties on the same basis provides more relevant information than permitting an entity to apply different measurement bases for owned and leased investment properties.

~~52~~58 IFRS 16 permits but does not mandate the revaluation of right-of-use assets that relate to a class of property, plant and equipment when the lessee applies the revaluation model in IAS 16 *Property, Plant and Equipment* to that class of owned assets. The option to measure right-of-use assets on the same basis as similar owned assets contributes to the relevance of the information provided. The impact on comparability is discussed further below.

Lease modifications

~~53~~59 The requirements in IFRS 16 related to lease modifications are generally consistent with the requirements for initial recognition and measurement of a lease in that, the modified lease is treated as a new lease. A lease modification differs from the reassessment of a lease liability as it reflects a change in the scope of a lease, for example, by adding or terminating the right to use one or more underlying assets, or a change in the consideration for a lease that was not part of the original terms and conditions.

~~54~~60 A lease may be modified to increase its scope by adding the right to use one or more underlying assets (such as by increasing the amount of leased floor space). If the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope, the modification is accounted for as a separate lease because there is no economic difference from entering into a separate contract. EFRAG considers that this requirement reflects the economic substance of the lease modification and therefore results in relevant information.

Sale and leaseback transactions

~~55~~61 IFRS 16 refers to the criteria in IFRS 15 to assess if a sale and leaseback transaction should be treated as a sale transaction or a financing transaction. In its endorsement advice on IFRS 15, EFRAG assessed that the criteria to recognise a sale transaction result in the provision of relevant information. EFRAG considers that there are no features in a sale and leaseback transaction ~~(i.e. the seller-lessee obtaining the right to use the underlying asset for a period of time)~~ that prevent the accounting for a sale by the seller -lessee as required by IFRS 15. In such a case, ~~as~~ the buyer-lessor purchases the underlying asset from the entity and the subsequent leaseback does not prevent the buyer-lessor from retaining control of the underlying asset.

Presentation

~~56~~62 IFRS 16 requires lessees to present right-of-use assets separately from other assets, and lease liabilities separately from other liabilities. EFRAG assesses that the separate presentation of right-of-use assets and lease liabilities results in the provision of relevant information because it enables users of the financial statements to better evaluate the respective risks associated with owned and leased assets and provides useful insights into the economic characteristics of the lease liability which may include specific features such as options and variable lease payments.

~~57~~63 IFRS 16 also requires a lessee to present separately:

(a) in profit or loss, the interest expense relating to the lease liability and the depreciation expense for the right-of-use asset; and

(b) in the statement of cash flows, the principal portion of cash repayments of the lease liability as financing activities and cash payments relating to interest consistently with other interest payments (as either operating or financing activities).

~~58~~64 Separating interest and depreciation provides cohesion between the lessee's statement of financial position, the statement of profit or loss and the statement of cash flows. As a result, the interest expense relates to the lease liabilities presented as financial liabilities and the cash outflow is classified consistently with the 'financing' nature of the liability. Similarly, the depreciation expense relates to the right-of-use assets presented as non-financial assets. In EFRAG's view, this presentation enhances the relevance of information, such as for use in calculating return on capital employed and leverage ratios.

~~59~~65 Overall, EFRAG assesses that the presentation requirements in IFRS 16 result in the provision of relevant information.

Disclosures

~~60~~66 IFRS 16 sets out an overall disclosure objective that requires lessees to disclose information that gives users a basis to assess the effect that leases have on the entity and identifies a two-tier level of disclosures:

(a) specific quantitative requirements that will arise with all leases; and

(b) additional entity-specific quantitative and qualitative information when necessary to meet the disclosure objective.

~~61~~67 EFRAG considers that including objective-based disclosure requirements, and requiring lessees to exercise judgement on how to meet these objectives, is more likely to lead to the provision of relevant information. Given that leases may include complex or unique terms and conditions, the most useful information can be different for different lease portfolios. Fully prescriptive disclosure requirements may be less effective in meeting the information needs of users.

~~62~~68 The specific disclosures required by IFRS 16 provide information that is useful for understanding the nature of a lessee's leasing activities and associated cash flows. For example, IFRS 16 requires a maturity analysis of lease liabilities that is based on the principles in IFRS 7 *Financial Instruments: Disclosures* where lessees are required to exercise judgement to determine the appropriate time bands. EFRAG assesses that having a prescriptive approach when identifying the appropriate time bands might not necessarily result in providing the most useful disclosures to users of financial statements. These disclosure requirements can enhance the predictive value of the financial information, especially when assessing the flexibility, restrictions and risks imposed by leases and evaluating any deviations from industry practice.

~~63~~69 EFRAG's overall assessment is that the disclosure requirements result in the provision of relevant information.

Transition requirements

~~64~~70 When first applying IFRS 16, lessees can choose either to apply a full retrospective approach to all periods presented (in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) or to apply a modified retrospective approach under which comparative figures are not restated.

~~65~~71 EFRAG assesses that under this latter approach, users may not be provided with the most useful information for confirming or correcting their past evaluations. The full retrospective approach provides better information on the trend information from the restated comparative period. However, EFRAG notes that the loss of information on trends under the modified retrospective approach will be compensated for by additional disclosures that provide information about leases that were previously classified as operating leases.

~~66~~72 At transition, as a practical expedient, lessees are not required to reconsider the previous assessment of whether contracts entered into before the transition date are, or contain, leases. EFRAG assesses that the relevance of the information about leases would be reduced if a large number of contracts that would not qualify as leases under IFRS 16 could continue to be treated as leases (or vice versa). However, EFRAG expects that the circumstances under which the identification of a lease would be different are limited. The main circumstance in which we envisage that a different conclusion would be reached relates to supply contracts in which:

(a) the customer is committed to buy substantially all the output from an underlying asset;

(b) the price formula is such that the customer does not pay a fixed or market price for each unit of output; and

(c) the customer does not control the underlying asset in accordance with IFRS 16.

~~67~~73 If all of these conditions are met, a contract would be classified as containing a lease under IAS 17 (as interpreted by IFRIC 4) but not under IFRS 16. Such contracts may exist, for instance, when one customer buys all the output from a power plant without controlling the power plant. EFRAG does not have any evidence to assess the frequency of this situation. EFRAG notes that the IASB concluded that these situations would not be frequent and that they could only identify a small population of contracts that would be classified differently such as when a customer is exposed to all the risks and rewards of an underlying asset but does not control it.

~~68~~74 Overall, EFRAG assesses that the transition requirements result in the provision of relevant information.

Lessor accounting

Asymmetry between lessee and lessor accounting

~~69~~75 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 on the following grounds:

(a) users indicated that they did not currently adjust lessors' financial statements for the effects of leases, indicating that the lessor accounting model in IAS 17 provides users with the information that they need;

(b) lessor accounting resulting from the requirements in IAS 17 is well understood and, unlike lessee accounting, is not deemed to be fundamentally flawed; and

(c) a symmetrical approach to lessor accounting would involve the partial derecognition of assets owned by lessors, compensated by the recognition of a right-of-use asset, which would be complex and costly to apply for minor presentation benefits.

Inclusion of variable lease payments based on an index or a rate in the Initial measurement of finance leases

76 Similar to its assessment for lessee accounting (see paragraphs 45-51), EFRAG assesses that including variable lease payments that are based on an index or rate in the initial measurement of finance lease assets by lessors provides relevant information because these payments represent the lessee's unavoidable obligation based on conditions at the applicable date.

77 EFRAG has also considered whether the requirement to exclude variable lease payments that are linked to future performance or use of an underlying asset by the lessee would result in the omission of relevant information, taking into account the predictability of such cash outflows. EFRAG observes that it may be difficult for a lessor to accurately estimate these variable lease payments which are based on the lessee's activity or usage and therefore such estimates would be subject to high level of measurement uncertainty.

78 EFRAG also observes that lessors are required to disclose income relating to variable lease payments that is not included in the measurement of the net investment in a finance lease.

79 As a result, EFRAG assesses that these requirements of IFRS 16 provide relevant information. [To address comment raised by EFRAG Board member]

Sublease arrangements

~~70~~80 IFRS 16 requires an intermediate lessor to account for a head lease (as lessee) and a sublease (as lessor) as two separate contracts by applying both the lessee and lessor accounting requirements. An intermediate lessor is not permitted to offset lease receivables and payables arising from a head lease and a sublease (or lease income and lease expenses relating to a head lease and a sublease of the same underlying asset) unless those receivables and payables meet the requirements for offsetting assets and liabilities.

~~71~~81 In its assessment of IAS 1, IAS 32 *Financial Instruments: Presentation*, IFRS 7 and IFRS 9 *Financial Instruments*, EFRAG concluded that the criteria for offsetting assets and liabilities (including financial assets and financial liabilities) led to the provision of relevant information. EFRAG considers that this would also be the situation for receivables and payables arising from leases.

~~72~~82 EFRAG assesses that the requirements result in useful information because, when the head lease and the sublease are negotiated separately with different counterparties, the obligations for an intermediate lessor that arise from the head lease are generally not extinguished by the terms and conditions of the sublease and exposures arising from those right-of-use assets and liabilities are different from the exposures arising from a single net lease receivable or lease liability. Therefore, presenting these arrangements on a net basis could provide misleading information about an intermediate lessor's financial position because it could obscure the existence of some arrangements and hence hinder the predictive or confirmatory value of the information.

~~73~~83 Conversely, when head leases and subleases are entered into with the same counterparty at or near the same time, an intermediate lessor would be required to consider the criteria for combining contracts which are similar to those in IFRS 15 (i.e. whether the contracts are negotiated as a package with a single commercial objective or the consideration to be paid in one contract depends on the price or performance of the other contract).

~~74~~84 In certain cases, an entity could lease a whole asset and lease out portions to other parties. If a portion is not physically distinct, it does not qualify as an identified asset, as explained in paragraph 19, unless it represents substantially all the capacity. In this case, the lessor does not apply IFRS 16 to the sublease, which results in the lessor maintaining the full right-of-use asset on its balance sheet.

~~75~~85 If the full capacity is sublet, although to multiple parties, some may argue that the economic position of the intermediate lessor is comparable whether the full capacity is sublet to one or several sub-lessees for the remainder of the head lease term, as the intermediate lessor only retains the credit risk associated with the subleases. However, EFRAG considers that the different accounting is justified by the fact that the intermediate lessor has not relinquished its control (and the sub-lessees have not gained control) over the use of the underlying asset and the intermediate lessor has not defeased the lease liability. Therefore, subleasing the full capacity to one entity or to more than one entity are not similar economic situations.

Disclosures

~~76~~86 EFRAG assesses that the disclosure requirements in IFRS 16 provide relevant information to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities. In particular, EFRAG observes that IFRS 16 requires a lessor to disclose:

(a) *information about the different components of lease income recognised during the reporting period*: EFRAG assesses that this disaggregation of lease income (for instance separately disclosing income relating to variable lease payments that do not depend on an index or a rate) enhances the usefulness and predictive value of information;

(b) *information about how the entity manages its risk associated with any rights it retains in the underlying asset*: EFRAG notes that the risks associated with the residual value of the leased assets are often a lessor's primary risks which can affect the profitability of the lease and therefore the disclosure will provide useful information about lessor's risk exposures and will enable users to evaluate the risks associated with residual asset and differentiate those risks from credit risk;

(c) *a disaggregation of each class of property, plant and equipment into assets that are subject to operating leases and assets that are not subject to operating leases*: thus allowing users to obtain information about leased assets that generate lease income separately from owned assets held and used by the lessor; and

(d) *for finance leases, a maturity analysis of the lease payments receivable, for a minimum of each of the first five years and a total of the amounts for the remaining years*: this will provide useful information about the timing of the cash flows and the lessor's liquidity risk.

Overall conclusion on relevance

~~77~~87 EFRAG's overall assessment is that the requirements in IFRS 16, especially the recognition of assets and liabilities by lessees for all leases (with limited exceptions) will result in relevant information~~.~~. Recognition of an asset over which the entity has obtained control has predictive value in that it assists users to assess the entity's ability to generate future cash inflows through the use of the underlying assets and enhances transparency about the capital employed. Recognition of a lease liability provides information about obligations to make future cash outflows and, hence, enhances transparency about an entity's financial leverage. [Based on proposal comments from EFRAG Board member]

~~78~~88 EFRAG has however identified certain limitations to relevance, including the optional recognition exemption for leases of low-value assets, the practical expedient to not separate non-lease components from lease components (paragraphs 33-39); the exclusion of variable lease payments based on usage or performance (paragraphs 45-51) and the determination of the lease term, in particular the subsequent reassessment of extension, termination and purchase options (paragraphs 54-55). However, these limitations have been assessed as contributing to an acceptable trade-off between the cost and complexity of implementing IFRS 16, on the one hand, and the relevance of the information on the other hand.

Reliability

~~79~~89 EFRAG also considered the reliability of the information that will be provided by applying IFRS 16. 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.

~~80~~90 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

~~81~~91 In its assessment of reliability, EFRAG has identified the following topics based on the criteria in paragraph 11:

(a) Lessee accounting

(i) Recognition of a right-of-use asset and a lease liability

(ii) Initial measurement of the right-of-use asset and the lease liability

(iii) Subsequent measurement of the right-of-use asset and the lease liability

(iv) Lease modifications

(v) Sale and leaseback transactions

(vi) Disclosures

(vii) Transition requirements

(b) Lessor accounting

(i) Sublease arrangements

(ii) Disclosures.

Lessee accounting

Recognition of a right-of-use asset and a lease liability

~~82~~92 EFRAG assesses that recognising right-of-use assets and lease liabilities provides information that reflects the substance of a lessee's rights and obligations in its lease contracts. In relation to the right-of-use asset, the lessee's economic position is similar to that of a legal owner of an asset, in the sense that it is in the position to decide on the use of the right-of-use asset and receive the economic benefits. The major difference is that the lessee is not entitled to the residual value of the asset at the end of the lease term.

~~83~~93 In relation to the liability, the lessee obtains control of the underlying asset as a result of the supplier's completion of its performance obligation and, as a consequence, the recognition of a lease liability faithfully represents the present and unconditional obligation accepted by the lessee to make lease payments.

Separating components of a contract

~~84~~94 Separating the lease components of a contract provides reliable information about the amounts of a lessee's right-of-use assets and lease liabilities because the amounts recognised reflect how a right-of-use asset could have been priced had it been in a separate contract.

~~85~~95 Excluding the non-lease components of a contract from recognition in the statement of financial position and statement of profit or loss faithfully represents the distinction between lease and non-lease assets, liabilities, income and expenses. This separation enables the faithful representation of the different economics underlying lease contracts and other contracts.

Initial measurement of the right-of-use asset and the lease liability

~~86~~96 IFRS 16 requires that the lease term reflects the duration-related extension and termination options in a lease contract to the extent it is reasonably certain the lessee will, or will not, exercise the option. The assessment of the lease term in IFRS 16 is based on the facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option. EFRAG considers that requiring an economic incentive provides a threshold that is more objective and practical than a threshold based solely on management's estimates or intention about the period during which the use of the underlying asset is expected to remain under the control of the lessee.

~~87~~97 As discussed above in the section on relevance (paragraph 44), the initial measurement of the lease liability restricts the amount of variable lease payments recognised to payments that are calculated using an index or a rate at the commencement date. The lessee does not estimate future increases in indexes or rates. EFRAG assesses that this provides reliable information as it avoids the risk of error in estimating future changes in the index or rate.

98 Variable lease payments that are linked to future performance or use of an underlying asset are also not included in the initial measurement of the lease liability. The measurement of these amounts can be highly uncertain and EFRAG assesses that the exclusion of these amounts from initial measurement of the lease liability improves its reliability.

~~88~~99 EFRAG notes that the measurement of the right-of-use asset and the lease liability requires judgement in areas such as the length of the lease term and whether payments are variable or in-substance fixed. EFRAG assesses that IFRS 16 contains sufficient guidance such that the level of judgement required is not excessive.

EXEMPTIONS AND PRACTICAL EXPEDIENTS ON RECOGNITION

~~89~~100 The optional recognition exemptions for short-term leases and leases of low-value assets have the potential to affect the completeness of information as their application results in the non-recognition of right-of-use assets and lease liabilities. Although leases of low-value assets are likely to be immaterial, the disclosure of the related expense may not mitigate the lack of recognition when leases of low-value assets are significant in aggregate, as no disclosure is required about the future lease commitments.

~~90~~101 The practical expedient permitting a lessee not to separate non-lease components from lease components may decrease the faithful representation of leases in a lessee's financial statements because the measurement of a right-of-use asset and associated lease liability may include amounts that do not arise from a lease. However, this practical expedient was introduced to help reduce complexity and costs for preparers. Disclosure of the application of this accounting policy option, without disclosure of the impact, will highlight to users that this practical expedient is being applied, without requiring the impact of applying this practical expedient and, consequently, negating the benefit inherent in it.

Subsequent measurement of the right-of-use asset and the lease liability

~~91~~102 EFRAG considers the subsequent measurement of the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses provides a faithful representation of the consumption of economic benefits derived from the use of the underlying asset over its period of use.

~~92~~103 Subsequent measurement of the lease liability on an amortised cost basis, subject to the adjustments due to lease modifications, discussed below in paragraphs 113–114, also provides a faithful depiction of the unwinding of the lessee's obligation to pay the amounts specified in the contract.

~~93~~104 Under IFRS 16, the lease liability is only reassessed for variable lease payments that are based on an index or rate when there is a change in the future lease payments. EFRAG considers that this requirement faithfully represents changes in the economics of the lease contract. IFRS 16 also requires a lessee to use a revised discount rate when the changes to lease payments are a result of a change in the lease term, a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset or a change in the floating interest rate. EFRAG assesses that this reflects the changes in the economics of a lease and therefore provides a faithful representation of the changes.

~~94~~105 Lessees are required to reassess options to extend, or terminate a lease or to purchase an underlying asset; only upon the occurrence of a significant event or a significant change in circumstances, that is within their control and that affects whether the lessee is reasonably certain to exercise, or not to exercise, these options.

~~95~~106 EFRAG acknowledges that, in principle, information on leases more faithfully represents the changes in economic conditions when extension, termination and purchase options are reassessed on a regular basis. However, EFRAG considers that requiring a lessee to reassess options in response to market-based events or changes that are not within its control would be unnecessarily costly and the resulting volatility would not always provide reliable information

~~96~~107 Overall EFRAG considers that an appropriate balance has been achieved between reliability and the cost and complexity by requiring reassessment only upon the occurrence of a significant event or a significant change in circumstances that is within its control of the lessee.

OTHER MEASUREMENT MODELS FOR THE RIGHT-OF-USE ASSET

~~97~~108 As set out in paragraphs 56–58 above, IFRS 16 permits the use of fair value to measure the right-of-use assets in two limited circumstances:

(a) it requires a right-of-use asset that meets the definition of an investment property to be measured at fair value if the lessee applies the fair value model to its owned investment properties; and

(b) it permits the revaluation of a right-of-use asset that is the same class of property, plant and equipment to which the lessee already applies the revaluation model in IAS 16.

~~98~~109 EFRAG acknowledges that measuring the fair value of a right-of-use asset may not always be straightforward because:

(a) active markets for right-of-use assets are often unavailable; and

(b) the lease agreement may include complex features such as options or variable lease payments.

~~99~~110 EFRAG observes that IFRS Standards permit the use of fair value for a broad range of non-financial assets (including assets within the scope of IAS 16, IAS 38 and IAS 40). IFRS 16 merely extends the use of fair value to some of the rights to use these non-financial assets. EFRAG also notes that the use of fair value is restricted to situations where fair value can be reliably estimated.

~~100~~111 In measuring a right-of-use asset at fair value, EFRAG acknowledges that, except in the situation where a sublease is already in place for the entire residual term of the right-of-use asset, the lessee would have to make a number of assumptions and not be able to rely on observable information. However, the use of assumptions and estimates is inherent in financial reporting and this, in itself, would not prevent the information from being reliable. Measuring operating leases rights at fair value is already possible under IAS 40, although on a voluntary basis; EFRAG is not aware of specific concerns about the application of the option, nor of its frequency.

~~101~~112 EFRAG therefore considers any reliability issues that arise when estimating the fair value of right-of-use assets are of a similar level to those that arise under other IFRS Standards.

Lease modifications

~~102~~113 IFRS 16 requires a lease modification to be accounted for as a new lease when there is an increase in scope by adding the right to use one or more underlying assets and the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope. EFRAG assesses that this results in reliable information as it provides a faithful representation of the substance of the lease modification in acknowledging that the modification is equivalent to a new lease.

~~103~~114 All other lease modifications are accounted for as a modification to the existing lease liability with a commensurate change to the right-of-use asset. Where a lease modification decreases the scope of a lease, a lessee decreases the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease and recognises a corresponding gain or loss. T~~t~~he lease liability is remeasured using the discount rate determined at the date of the modification, in order to reflect the impact of the timing of the modification ~~and the right-of-use asset is adjusted to reflect the change to the lease and a gain or loss is recognised~~. EFRAG assesses this provides a faithful representation of the decrease in scope of a lease as it aligns the recognition of a gain or loss with the change in the lessee's rights and obligations under the lease.

Sale and leaseback transactions

~~104~~115 EFRAG assesses that the requirements in IFRS 16 result in accounting for sale and leaseback arrangements in accordance with the substance of the transaction. When the sale component does not meet the requirements in IFRS 15, no sale is recognised by the seller-lessee and no purchase is recognised by the buyer-lessor and both parties account for the transaction as financing.

~~105~~116 When a sale has occurred (i.e. when it meets the criteria in IFRS 15), IFRS 16 restricts the amount of the gain or loss to be recognised to the interest in the value of the underlying asset at the end of the leaseback and no gain is recognised on the right-of-use asset. EFRAG assesses that this provides a faithful representation of the transaction because, from an economic standpoint, the seller-lessee has retained its right to use the asset and only transferred the interest in the residual asset to the buyer-lessor.

Disclosures

~~106~~117 As discussed above in the section on relevance (paragraphs 66–69), IFRS 16 requires a lessee to provide disclosures on:

(a) specific quantitative requirements that will arise for all leases; and

(b) additional entity-specific quantitative and qualitative information when necessary to meet the disclosure objective.

~~107~~118 Lessees are required to apply judgement to determine which additional disclosures are necessary to meet the overall disclosure objective and IFRS 16 provides examples of such additional disclosures. In EFRAG's view, this objective-based approach ensures that entity-specific information is provided about features of leasing activities that can be particularly complex or contract-specific and contributes to the completeness of the information about a lessee's leasing activities. For example, IFRS 16 requires a lessee to disclose information about short-term leases and leases of low-value assets whenever a lessee has elected to apply the recognition exemptions. EFRAG observes that, in such cases, a lessee needs to assess whether additional disclosures are required, such as the remaining lease term of leases of low-value assets, for the information to be complete.

Transition requirements

~~108~~119 EFRAG considers that the modified retrospective transition method could affect reliability as it would not necessarily result in complete information. However, this method was developed to reduce costs for preparers as the full retrospective approach could be costly to implement. To compensate any loss in information, IFRS 16 requires additional disclosures to help users to understand the effect of applying IFRS 16 for the first time.

~~109~~120 Therefore, EFRAG is of the view that the transition requirements provide an acceptable trade-off between the cost and complexity of implementing IFRS 16, on the one hand, and the completeness of the information provided to users.

Lessor accounting

Inclusion of variable lease payment based on an index or rate in the measurement of finance leases

121 Similar to the assessment for lessees (see paragraphs 97 to 98), EFRAG considers that restricting the amount of variable lease payments included in the initial

assessment of the lessor's net investment in a finance lease to payments that are calculated using the current level of an index or ~~a~~ rate~~–~~ provides reliable information. This is because the measurement considers only payments that are unavoidable under the lease agreement based on current conditions and avoids the risk of error in estimating future changes in the index or rate. [Paragraph added to address comment by EFRAG Board member]

Sublease arrangements

~~110~~122 EFRAG considers that, when an entity enters in a head lease and a sub-lease of the same underlying asset with two different parties, the requirements to present separately payables for the head lease and receivables for the sub-lease (without off-setting) provides a faithful representation of the two transactions, due to the same reasons presented above in paragraphs 81-84.

Disclosures

~~111~~123 As discussed above in the section on relevance (paragraph 86), the disclosure requirements in IFRS 16 provides essential information on:

(a) disaggregation of the different components of lease income;

(b) the risks associated with the residual value of the leased assets which are often a lessor's primary risks together with the credit risks associated with the lease payments;

(c) the classes of property, plant and equipment that are subject to operating leases and those that are not; and

(d) any other disclosure necessary to meet the disclosure objective in IFRS 16.

~~112~~124 EFRAG assesses that the disclosure requirements contribute to the completeness of information about the effect that leases have on the financial position, financial performance and cash flows of the lessor.

Overall conclusion on reliability

~~113~~125 EFRAG's assessment is that IFRS 16 leads to the provision of reliable information. Limitations to reliability have been identified in particular relating to the recognition exemptions (see paragraphs 100-101) and to the determination of lease term (see paragraphs 105-107). However, those requirements have been assessed to provide an acceptable trade-off between the cost and complexity of implementing IFRS 16, on the one hand, and the completeness and faithful representation of the information provided to users.

Comparability

~~114~~126 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.

~~115~~127 EFRAG has considered whether IFRS 16 results in transactions that are:

(a) economically similar being accounted for differently; or

(b) economically different being accounted for as if they were similar.

~~116~~128 The key reason for issuing IFRS 16 is that users have indicated that the assets and liabilities created by lease contracts should be recognised by lessees. This, in general, results in enhanced comparability for assets and liabilities within and between entities.

~~117~~129 Based on the criteria enumerated in paragraph 11, EFRAG considers that the main factors to be assessed in relation to IFRS 16, as far as comparability is concerned, relate to:

(a) whether the requirements in IFRS 16 will be interpreted in a consistent manner;

(b) whether the guidance in IFRS 16 is adequate on all significant matters within its scope;

(c) whether IFRS 16 includes exemptions and practical expedients that could impair comparability; and

(d) the transition requirements.

Will the requirements in IFRS 16 be interpreted in a consistent manner?

~~118~~130 Application of IFRS 16 will be straightforward in many cases and not result in any issues that would reduce comparability. However, it could be argued that the judgements required in some areas could limit comparability. This could arise when IFRS 16 requires various factors to be considered and those factors contain an unusual degree of uncertainty or where the information is extremely difficult to obtain.

~~119~~131 Making judgements is inherent in principles-based standards and may be necessary to achieve comparability rather than uniformity (which, in some instances, disregards the substance of a transaction or event). However, EFRAG assesses that the level of judgement required by IFRS 16 is not so exceptional in nature that it would be impracticable to apply the requirements. Principles-based standards may increase the risk of diversity in practice developing, at least over the first few years of application before practices settle and this is an unavoidable price to pay. EFRAG is of the view that the extensive application guidance included in IFRS 16 provides the relevant framework for the exercise of judgement, and illustrates the principles included in IFRS 16. EFRAG also observes that IFRS 16 has removed the need for lessees to assess whether a lease is an operating lease or a finance lease, thereby removing a major area where judgement was required.

~~120~~132 EFRAG assesses that the main areas where judgement is required by IFRS 16 are:

(a) determining whether a contract contains a lease;

(b) determining the lease term (i.e. whether lease extension and termination options are 'reasonably certain' to be exercised by the lessee);

~~(b)~~(c) determining whether payments are variable or in-substance fixed;

(d) determining whether a sale has occurred in a sale and leaseback transaction (for seller-lessees);

~~(c)~~(e) for lessees and lessors, determining the discount rate; and

~~(d)~~(f) for lessors, determining whether a contract is an operating or a finance lease.

Determining whether a contract contains a lease

133 EFRAG has carried out specific field test with a number of preparers, across 13 industries and 9 jurisdictions, on the complexity of determining whether a contract is a lease. ~~on identifying a lease (see paragraph 83 of Appendix 3). Participants in that field test found that identifying whether a contract contained a lease did not require exceptional judgement.~~ Although EFRAG has heard that, in some industries, the assessment may require a greater degree of judgement for certain types of contracts; especially when both the customer and the supplier make decisions about the use of an item, no situations were identified in which the application would be 'overly complex' and beyond the level of judgement required by a principles-based standard.

~~121~~134 The context and findings of the field work are described in more detail in a separate EFRAG Secretariat paper available here[3]. [Proposal by EFRAG Board member]

Determining the lease term

~~122~~135 Under IFRS 16, the lease term encompasses the non-cancellable periods of a lease contract plus periods to extend or terminate leases, based on a 'reasonably certain' threshold for both extension and termination options. Assessing whether exercise or non-exercise of an option is reasonably certain requires consideration of all relevant facts and circumstances. EFRAG considers that IFRS 16 does not introduce new concepts relating to lease term determination and requires preparers (both lessees and lessors) to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise an option.

136 IFRS 16 also includes extensive guidance on the types of facts and circumstances that an entity should consider as well as assisting them to analyse potential break clauses in the contract. In EFRAG's view, this guidance is likely to help entities identify the relevant factors and therefore should generally ensure consistent application.

Determining whether payments are variable or in-substance fixed

137 EFRAG acknowledges that the level of judgement required to assess whether variable lease payments are in-substance fixed payments can in some cases be important and could result in inconsistent application and therefore may limit comparability. EFRAG however observes that IFRS 16 includes examples in the application guidance of the types of payments that are considered to be in-substance fixed payments to provide help in applying the requirement. [Paragraph included to address comment by EFRAG Board member]

Determining whether a sale has occurred in a sale and leaseback transaction (seller-lessees)

~~123~~138 IFRS 16 requires the transfer of an asset to be accounted for as a sale if it meets the requirements of IFRS 15. In its endorsement advice on IFRS 15, EFRAG assessed that the criteria in the Standard to determine whether a sale has occurred would lead to comparable information. EFRAG sees no reason why this would not also apply to sale and leaseback transactions.

~~124~~139 EFRAG considers that IFRS 15 and IFRS 16 taken together ensure that sale transactions will be accounted similarly regardless of whether they are entered into separately or as part of a sale and leaseback arrangement. Hence, EFRAG considers comparability will be enhanced, across entities and within entities when other forms of transactions that have the same economic effects (e.g. leaseback transactions structured in the form of a lease and leaseback).

Determining the discount rate for lessees and lessors

~~125~~140 EFRAG acknowledges that the rate implicit in a lease agreement may be difficult for lessees to determine. This is because some of the inputs into this calculation may not be known by the lessee such as the lessor's estimate of the residual value of the underlying asset at the end of the lease or any initial direct costs of the lessor.

~~126~~141 EFRAG however observes that, similar to IAS 17, IFRS 16 permits a lessee to discount the lease liability using its incremental borrowing rate and provides guidance to ensure consistent determination. In particular, EFRAG observes that IFRS 16 defines the lessee's incremental borrowing rate to take into account the terms and

[3] See EFRAG Secretariat paper TITLE for the details of this outreach.

conditions of the lease. EFRAG considers that this guidance will help preparers achieve consistent application.

Determination by lessors whether a contract is an operating or a finance lease

~~127~~142 IFRS 16 carries forward the accounting model for lessors in IAS 17 (including the terminology) and in particular the need to classify, at inception of the contract, whether a lease is a finance lease or an operating lease. EFRAG acknowledges that such determination requires the exercise of judgement. EFRAG considers, based on the feedback it received in response to the consultations on the 2010 and 2013 Exposure Drafts that led to IFRS 16, that the lessor accounting model in IAS 17 was generally well understood and not deemed to be in need of change. Therefore, in EFRAG's view, retaining the principles and terminology in IAS 17 helps to achieve consistent application.

~~128~~143 EFRAG has also considered the requirement for intermediate lessors to classify subleases by reference to the right-of-use asset and not the underlying asset. EFRAG acknowledges that, as a result, a lessor that leases two similar properties on similar terms could account for those leases differently if the head lessor owned one of the properties and leased the other property. This is because in the first case the classification will be determined based on the underlying asset and in the second case on the right-of-use asset.

~~129~~144 However, EFRAG considers that the different accounting is justified as the lessor is in a different economic position depending on whether it owns or leases an asset that, in turn, it leases to other parties. In an operating lease, the lessor owns the underlying asset and would expect to derive economic benefits from the underlying asset at the end of the existing lease term. In a sublease, the intermediate lessor has only a right to use the asset for a period of time and, if the sublease is for all of the remaining term of the head lease, the intermediate lessor has transferred that right to another party via the sublease.

Is the guidance in IFRS 16 adequate on all significant matters within its scope?

~~130~~145 EFRAG assesses that IFRS 16 provides guidance on all of the most important issues, including providing additional guidance on areas where the previous guidance was considered to be insufficient. The following paragraphs consider a number of areas where the guidance in IFRS 16 contributes to the comparability of the resulting information.

Scope exception

~~131~~146 IFRS 16 introduces a scope exception for leases of intangible assets that are within the scope of IAS 38. EFRAG considers that permitting a lessee to apply IFRS 16 to leases of other intangible assets limits the comparability of information, because:

(a) a lessee does not have to justify the election; and

(b) if a lessee elects not to apply IFRS 16, no other Standard explicitly requires disclosure of information about these contracts.

~~132~~147 However, as mentioned above, EFRAG has no evidence that leases of intangible assets (other than the ones referred to in paragraph 25 above) are frequent, in particular leases that are classified as finance leases in accordance with IAS 17. Hence, it does not have evidence that the optional application in IFRS 16 will result in significant divergence in practice. Moreover, EFRAG notes that entities already recognising assets and liabilities for such leases will not be prevented from continuing to do so, and, depending on facts and circumstances, may be required to continue under the provisions of IAS 8. Furthermore, EFRAG observes that these entities would be required (by IAS 1) to disclose this accounting policy election if it was significant.

Separating components of a contract

~~133~~148 EFRAG assesses that separating the lease and non-lease components of a contract by allocating the consideration to each component enhances comparability by ensuring a similar accounting for contracts regardless of whether they are entered into separately or within a single contract with multiple components.

~~134~~149 In EFRAG's view, maximising the usage of observable information when allocating the contract consideration to both lease and non-lease components ensures comparability across entities by applying the same basis for selecting data for valuing different contract components. Further, EFRAG notes that the application guidance included in IFRS 16 provides a framework for the application of judgement.

Lease modifications

~~135~~150 EFRAG assesses the requirements for lease modifications will enhance comparability as lease modifications that are in substance akin to the creation of a new lease will be accounted for as such regardless of the contractual form of the modification (i.e. whether a new lease agreement is entered into or whether revisions are made to the existing lease).

Measurement of the right-of-use asset and the lease liability

~~136~~151 The basis for the initial measurement of the right-of-use asset and lease liability is cost, based on the present value of the lease payments due over the lease term; therefore an entity with a lease for a shorter period of time will recognise a lower lease liability and right-of-use asset than an entity with a lease for a longer period.

~~137~~152 EFRAG assesses that this allows users to appropriately compare the financial position between entities that lease for different periods, and between entities that lease and entities that purchase. An entity that leases an asset for a shorter period of time retains more flexibility that an entity that leases the same asset for its full economic life or purchases it, because the entity that leases an asset for a shorter period of time is not obligated beyond the lease term. However, this entity is exposed to the risk that the asset, or a similar one, will not be available at the end of the lease, so it is appropriate that the measurement of its right-of-use asset reflects the terms and conditions of the contract.

153 IFRS 16 permits other measurement models for the right-of-use asset which is consistent with the measurement requirements in other IFRS for similar owned assets. This, in EFRAG's view, may provide a basis for enhanced~~es~~ comparability of financial information within an entity. However, EFRAG considers that limitations exist as to comparability both within and between entities insofar as:

(a) IFRS 16 permits but does not mandate the revaluation of right-of-use assets that relate to a class of property, plant and equipment when the lessee applies the revaluation model in IAS 16 *Property, Plant and Equipment* to that same class of owned assets; and

~~(a)~~(b) ~~but at the same time might result in limited~~ comparability between entities may be limited as a result of different entities ~~which have~~ choosing to ~~sen to~~ apply different measurement models~~ may be limited~~. [Proposal by EFRAG Board member]

Presentation

~~138~~154 EFRAG is of the opinion that the separate disclosure of right-of-use assets from other assets and lease liabilities from other liabilities enhances the comparability of the financial statements and as such allows:

(a) comparison across entities in the way they derive and finance economic benefits from their owned and leased assets; and

(b) comparison within the same entity by allowing a comparison between the return on investment on owned and leased assets.

~~139~~155 EFRAG notes that separating interest and depreciation in the lessee's statement of profit or loss improves cohesion between the financial statements by presenting separately the interest expense arising from the lease liability and the depreciation expense related to the right-of-use asset. EFRAG acknowledges that this would also create greater comparability, in particular in reflecting the effects of a lease in profit or loss, between entities that borrow to buy assets and those that lease similar assets.

~~140~~156 EFRAG understands that the approach for classifying lease payments in the statement of cash flows is aimed at obtaining a cohesive presentation of lease contracts in the financial statements. However, EFRAG assesses that making the decision on the grounds of cohesiveness limits the comparability between cash flows of repayments of principal for leased assets, which would be classified as financing cash flows and payments for assets purchased on deferred payment terms which would be classified as investing cash flows. This, in EFRAG's view, could impose limitations to comparability of financial information for economically similar transactions both within an entity and between entities.

Does IFRS 16 include exemptions and practical expedients that could impair comparability?

~~141~~157 For comparability purposes, the use of exemptions and practical expedients (the optional recognition exemption for short-term leases and leases of low-value assets, and the practical expedient to not separate non-lease components from lease components) results in like items being accounted for differently. Because IFRS 16 does not limit the use of these exemptions and practical expedients to situations where the impact would not be material, it may limit comparability. However, participants in EFRAG's 2014 limited survey on simplifications to the lessee accounting model identified that exemptions and practical expedients were necessary to reduce complexity and implementation costs.

~~142~~158 EFRAG also observes that the IASB has conducted fieldwork to assess the effect that low-value asset leases would have if the right-of-use assets and lease liabilities were recognised in the financial statements of lessees and concluded that, in most cases, assets and liabilities arising from leases within the scope of the exemption would not be material, even in aggregate.

~~143~~159 Finally, EFRAG notes that IFRS 16 requires disclosures when these exemptions and practical expedients are used which may mitigate, in part, the loss of comparability (paragraphs 36-38). As a result, EFRAG assesses that the operational benefits provide an adequate offset to the possible limitations in comparability.

Transition requirements

~~144~~160 Comparability, both between entities and over time within an entity, could be limited by the following transition requirements:

(a) permitting entities not to reassess whether a contract is, or contains, a lease for both:

(i) contracts that were previously identified as leases; and

(ii) contracts that were not previously identified as containing a lease.

(b) permitting a modified retrospective application; and

(c) prohibiting an entity from reassessing sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale.

~~145~~161 EFRAG assesses that, as a consequence of paragraph 160(a) above, not all leases as of the effective date of IFRS 16 would be accounted for similarly on an ongoing basis. The period during which comparability might be reduced could extend over a long period of time.

~~146~~162 EFRAG also observes that the modified retrospective transition method results in consistent presentation of leases under previous IFRS in the comparative years but not between comparative and current periods as entities applying this approach are prevented from restating comparative information. EFRAG however notes that, when the modified retrospective transition method is used, additional disclosures are required to help users of financial statements understand the effect on trend information.

Overall conclusion on comparability

~~147~~163 IFRS 16 requires the exercise of judgement in many areas (including the disclosure requirements). Judgements are unavoidable in principles-based standards and may be necessary in order to achieve comparability rather than uniformity (which in some instances disregards the substance of a transaction or event). However, EFRAG considers that the level of judgement required by IFRS 16 is not so exceptional that it would generally result in information that is not comparable.

~~148~~164 EFRAG's overall assessment is that the requirements in IFRS 16 will result in comparable information. Limitations to comparability have however been identified in relation to:

(a) the presentation of cash payments by a lessee in the statement of cash flows (see paragraphs 155-156);

(b) the optional recognition exemption for leases of low-value assets, and the practical expedient to not separate non-lease components from lease components (see paragraphs 157-159); and

(c) the transition period and the immediately following periods, caused by the different transition options permitted (see paragraphs 160-162).

~~149~~165 These limitations to comparability are however balanced against the overall relevance of the resulting information and the reduced cost and complexity for preparers.

Understandability

~~150~~166 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business, economic activity and accounting, and the willingness to study the information with reasonable diligence.

~~151~~167 Although there are a number of aspects related to the notion of 'understandability', EFRAG notes that most of the aspects are covered by the discussion above on relevance, reliability and comparability.

~~152~~168 As a result, EFRAG assesses that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 16 is understandable, is whether that information will be unduly complex.

~~153~~169 EFRAG considers that principles-based standards generally enhance understandability for users when the principles are clearly articulated. Complexity often arises when standards become rules-based because many specific transactions are dealt with in great detail and/or inconsistently even though they are economically similar. Exemptions and practical expedients, may also cause complexity in understanding the amounts recognised in the financial statements.

~~154~~170 In assessing whether IFRS 16 is introducing undue complexity, EFRAG has considered the following:

(a) Does the single accounting model for lessees provide understandable information?

(b) Do the exemptions and practical expedients in IFRS 16 introduce undue complexity?

(c) Do the presentation and disclosure requirements result in understandable information (for lessees and lessors)?

Does the single accounting model for lessees provide understandable information?

~~155~~171 The selection of a single or dual measurement model for lessees was the subject of substantial debate.

~~156~~172 The decision to use a single measurement model in IFRS 16 addresses the concerns raised by some participants in the outreach activities undertaken by EFRAG between 2013 and 2015 that a dual measurement model would be complex to apply and understand. These participants considered that a single measurement model would be less complex to apply and easier to understand, as it removes the need to apply judgement in order to classify leases.

~~157~~173 EFRAG notes that, although~~—~~ IFRS 16 ~~does not~~ introduces a ~~new~~few new ~~principles~~ concepts (such as right-of-use assets or in-substance fixed payments) it ~~but is~~ ~~essentially extend~~principally extends~~ing~~ the well-understood ~~principles~~ accounting treatment currently applicable to ~~for~~ finance leases to all leases. In addition, the subsequent measurement requirements are similar to those for other non-financial assets and financial liabilities. For example, right-of-use assets are depreciated in a similar way to depreciation of other non-financial assets, such as property, plant and equipment, and interest is recognised on lease liabilities in a similar way to interest on other financial liabilities. [Proposal by EFRAG Board member]

Do the exemptions and practical expedients in IFRS 16 introduce undue complexity?

~~158~~174 As discussed above in the sections on relevance, reliability and comparability, IFRS 16 includes exemptions and practical expedients both upon transition and on an ongoing basis.

~~159~~175 EFRAG considered whether these exemptions and practical expedients would result in undue complexity. The requirements in IFRS 16 for the optional recognition exemption for short-term leases and for leases of low-value assets are clearly articulated and EFRAG considers that the related disclosures will enable users will be able to understand the effect it has on the financial statements. In EFRAG's view practical expedients at the date of initial application are useful and prevent undue complexity. However, EFRAG is concerned that the restatement of comparative information of previous periods using these practical expedients is prohibited. Although entities may present *pro forma* information, EFRAG considers that this would be less understandable to users than restating comparative information. [Proposal by EFRAG Board member]

~~160~~176 The optional practical expedient allowing lessees not to separate lease and non-lease components (applicable by classes of underlying asset) has the potential to impair understandability. Although users may find it difficult to understand the impact of the use of this practical expedient by a lessee and the resulting effect on the financial statements, EFRAG expects that non-separation is most likely to occur when the impact is less significant. However, f~~F~~or ~~because~~ entities ~~will generally prefer to separate~~ with material non-lease components, entities are expected

~~consider~~other factors may influence the decision- such as ~~the~~ avoiding an- ~~of a lease contract to avoid overstat~~overstatement of ~~ing~~ assets and liabilities arising from a lease in the statement of financial ~~position~~position, or, the presentation of the non-lease component expense in the statement of income. [Proposal by EFRAG Board member]

~~161~~177 Overall, EFRAG assesses that the benefit of this exemption for preparers provides an adequate offset to the possible reduction in understandability.

Do the presentation and disclosure requirements result in understandable information?

Lessees

~~162~~178 The presentation requirements in IFRS 16 reflect the cohesion of the recognition requirements for lease activities between the statement of financial position, statement of profit or loss and the statement of cash flows. Consequently, EFRAG assesses that this cohesiveness results in improved understandability of the reported financial information.

~~163~~179 EFRAG considers that the separate presentation of:

(a) right-of-use assets from other assets enhances the understandability of an entity's choice between the use of leased and owned assets to derive economic benefits;

(b) lease liabilities from other liabilities provides information that is useful in understanding a lessee's obligations from lease arrangements and highlights the contractual link to a corresponding asset;

(c) interest expense from depreciation expense; and

(d) cash payments for the principal portion of the lease liability from cash payments for the interest portion of the lease liability provides cohesion between the lessee's statement of financial position, the statement of profit or loss and the statement of cash flows.

~~164~~180 IFRS 16 requires a lessee to disclose information about its leases in a single note or separate section in its financial statements. EFRAG assesses that requiring all disclosures about a lessee's leasing activities in one place makes it easier for users to assess the effect of these activities on the financial statements.

~~165~~181 The principle-based overall disclosure objective enables lessees to determine the most appropriate way to disclose information with complex terms and conditions whereas fully prescriptive disclosure requirements may be less effective in enabling users to understand a lessee's leasing activities. The decision to include a disclosure objective instead of requiring disclosure of specific information about complex leases was to address concerns raised by some constituents that it would be difficult to provide meaningful information when an entity has a large volume of complex leases.

~~166~~182 EFRAG assesses that the presentation and disclosure of information relating to a lessee's leasing activities will generally improve users' understanding of the effect of these activities on the financial statements.

Lessors

~~167~~183 IFRS 16 provides enhanced disclosures beyond those previously required under IAS 17. EFRAG assesses that the enhanced disclosure requirements for lessors relating to a lessor's exposure to residual asset risk and credit risk enable users of financial statements to understand how a lessor manages its risk exposures and result in improved understandability about a lessor's leasing activities.

Overall conclusion on understandability

184 EFRAG has assessed that the requirements in IFRS 16 result in understandable information even if IFRS 16 introduces some new concepts (such as right-of-use

assets or in-substance fixed payments) and includes a ~~although some complexity may arise because of the~~ number of exceptions to the general principles and practical expedients available both upon transition and on an ongoing basis. However, EFRAG has assessed that these exceptions and practical expedients ~~are not so complex that they~~ would ~~impair~~not impair understandability. [Proposal by EFRAG Board member]

~~168~~185 Therefore, EFRAG's overall assessment is that IFRS 16 satisfies the understandability criterion in all material respects.

Prudence

~~169~~186 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.

Note to the EFRAG Board

One Board member proposes to replace the definition of prudence as follows. This proposal has not been included in the Preliminary Consultation Document as the EFRAG Board has previously approved the definition used in the Preliminary Consultation Document. Further, there is no explicit definition of prudence or mention of asymmetry in the Accounting Directive. Accordingly, some of the consequential proposed changes have not been taken up.

For the purpose of this endorsement advice, prudence is defined in the light of the Accounting Directive (Article 6.1(c)) as ~~caution in conditions of uncertainty. In some circumstances, prudence requires~~ asymmetry in recognition and measurement since profit is recognised when made whereas all arising liabilities and negative value adjustments are immediately recognized ~~such that assets or income are not overstated and liabilities or expenses are not understated~~.

~~170~~187 EFRAG has considered in its assessment whether the following requirements in IFRS 16 are consistent with the concept of prudence:

(a) recognition of liabilities arising from a lease contract;

(b) the initial measurement of right-of-use assets and lease liabilities by lessees;

(c) the subsequent measurement of right-of-use assets by lessees;

(d) the use of fair value as a measurement basis for certain right-of-use assets; and

(e) the accounting for sale and leaseback transactions.

Recognition of liabilities arising from lease contracts

~~171~~188 ~~he concept of prudence requires that liabilities are not understat~~By requiring the recognition of liabilities arising from all lease contracts (with limited exceptions) corresponding to the unavoidable payments to be made under the lease, IFRS 16 ~~is consistent with~~does not contradict the concept of prudence. [Proposal by EFRAG Board member]

Initial measurement of right-of-use assets and the lease liabilities by lessees

~~172~~189 The initial measurement of the lease liability only includes fixed payments (including in-substance fixed payments) and those variable lease payments that depend on an index or a rate. EFRAG observes that the lessee has no ability to avoid variable payments that depend on an index or a rate under the terms of the lease and therefore these are appropriately included in the initial measurement of the lease liability.

~~173~~190 IFRS 16 requires the variable payment clauses to be analysed to determine whether or not they are in-substance fixed payments. This limits the risk of understatement of the lease liabilities by ensuring that payments that contain, in form, variability but which are, in substance, fixed are included in the measurement at inception of the lease liability and right-of-use asset. EFRAG assesses that including in-substance fixed payments in the lease liability leads to prudent accounting.

~~174~~191 IFRS 16 requires that variable lease payments that are linked to future performance or use of an underlying asset be excluded from the initial measurement of the lease liability. Similarly, a lessee does not estimate future increases in indexes or rates, and only considers the index or rate as at the commencement date. Some would consider that the exclusion of these payments could result in the understatement of the lease liability.

~~175~~192 However, EFRAG observes that uncertainty exists on both the recognition and the measurement of such payments which remain avoidable by the lessee until performance or use occurs. As explained in paragraph 47 above, there is an inherently high level of measurement uncertainty in assessing variable lease payments based on usage or performance as the assessment depends on the future activity of the lessee. Therefore, excluding these payments from the measurement of the lease asset (and providing disclosures to ensure that users can estimate the effect on the lease liability) is consistent with the concept of prudence.

~~176~~193 EFRAG also considers that the requirements for the lessee, when initially determining the lease term, to consider whether it is reasonably certain to exercise extension and termination options by looking at all relevant facts and circumstances that create an economic incentive to exercise, or not to exercise, the option leads to prudent accounting and reduces the risk that non-substantive clauses are taken into account to increase or reduce the lease term beyond what is economically reasonable for the lessee.

~~177~~194 EFRAG also notes that the reassessment as to whether a lessee is reasonably certain to exercise, or not to exercise, an option only occurs in the case of an event (or a change in facts or circumstances) that is within the control of the lessee. Limiting the reassessment requirements in this way is prudent because only events and factors that the lessee has control over are considered as opposed to reassessing options in response to external events.

~~178~~195 Overall, EFRAG assesses that the initial measurement of lease liability ensures that the unavoidable payments arising from the lease contract are not understated. The initial measurement of the lease liability has a direct effect on the initial measurement of the right-of-use asset as the lease liability is the main component in that measurement. All of the above assessments on the impact of the initial measurement of the lease liability are therefore also applicable to the right-of-use asset and ensures that the asset is not overstated. As a result, the initial measurement by lessees of right-of-use assets and lease liabilities leads to prudent accounting in that the liability does not understate the required payments and the asset is subject to an impairment test to ensure that it is not overstated. [Response to comment by EFRAG Board member]

Subsequent measurement of right-of-use assets by lessees

~~179~~196 After the commencement date, the right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment losses, adjusted only for remeasurements due to lease modifications (unless the measurement options in IAS 16 or IAS 40 are applied; see below). EFRAG observes that, overall, the requirements are aligned with those applicable to owned property, plant and equipment, including the fact that a lessee should apply the impairment requirements of IAS 36 *Impairment of Assets* to the right-of-use asset. These requirements are assessed to lead to prudent accounting.

~~180~~197 Further, EFRAG notes that for lease modifications that increase the consideration paid for a lease, the change to the lease liability is accounted for as an increase in the carrying amount of the right-of-use asset even if the scope or the term of the lease has not changed. Some might consider that this requirement results in the overstatement of the right-of-use asset as the 'value' of the right-of-use asset has not changed and therefore the increase in lease cost should be expensed. However, EFRAG considers that such a lease modification represents a change in the cost of the right-of-use asset as a result of the modification. EFRAG assesses that, given that lease assets are subject to an impairment test, it is not imprudent to increase the carrying amount of the right-of-use asset for this ~~reason (and adjust the lease liability accordingly) and also considers that any potential impairment would be captured by applying IAS 36~~. [Response to comment by EFRAG Board member]

Use of fair value as a measurement basis for certain right-of-use assets

~~181~~198 The Accounting Directive establishes a link between the use of a cost method and prudence by stating that the cost method 'ensures the reliability of information contained in financial statements' (Recital 18). However, the Directive also acknowledges the usefulness of fair value measurement when it results in the provision of more relevant and comparable information and permits the use of fair value for a broad range of fixed assets and for some categories of financial instruments.

~~182~~199 Consistent with the above, EFRAG considers that exercising prudence does not, in itself, rule out measurement at fair value (or any other form of current value) provided that estimates have the appropriate level of reliability, and the use of current values provides relevant information.

~~183~~200 In that respect, EFRAG observes that existing IFRS Standards already permit the use of fair value for a broad range of non-financial assets and IFRS 16 merely extends this option to the right-of-use asset in situations where it can be reliably estimated.

~~184~~201 As mentioned in paragraph 111, EFRAG considers that the use of assumptions and estimates to determine the fair value of right-of-use assets (including the use of non-observable inputs) would not in itself prevent the information from being reliable. Therefore, EFRAG assesses that the use of fair value as the measurement basis for the rights to use investment property and property, plant and equipment would not raise concerns about prudence.

Accounting for sale and leaseback transactions

~~185~~202 Sale and leaseback accounting relies on the principles in IFRS 15 to determine if the transfer of an asset is, or is not, a sale. This assessment requires the exercise of judgement due to the diversity of economic reasons underlying such transactions.

~~186~~203 EFRAG notes that applying the principles in IFRS 15 to sale and leaseback transactions is prudent accounting because the recognition of proceeds of the sale will be limited to 'completed' sales, and financial statements will therefore appropriately reflect profits made during the reporting period.

~~187~~204 In accordance with IFRS 16, a seller-lessee only recognises the amount of gains or losses relating to the rights transferred to the buyer-lessor. Therefore, when a sale and leaseback transaction meets the conditions to be recognised as a sale, only the portion of the gain corresponding to the residual asset at the end of the leaseback is recognised by the lessee.

~~188~~205 EFRAG considers that this leads to prudent accounting because, from an economic standpoint, the seller-lessee has sold only its interests in the value of the underlying asset at the end of the leaseback and has retained its right to use the asset for the duration of the leaseback.

~~189~~206 If the sale consideration or leaseback rentals are not at market rates, and the transaction does not meet the requirements for a transfer in IFRS 15, no sale and no purchase are recognised: the transaction is, in substance, a financing arrangement. Therefore, any below-market term is accounted for as a prepayment of lease payments and any above-market term is accounted for as additional financing provided by the buyer-lessor to the seller-lessee. EFRAG assesses that this adjustment leads to prudent accounting. Lease payments and the sale price in a sale and leaseback transaction are typically interdependent because they are negotiated as a package. The requirements in IFRS 16 ensure that any gains on disposal is not recognised until realised ~~are not overstated~~ and any losses are ~~not understated~~provided for by the seller-lessee and that the carrying amount of the asset is not misstated by the buyer-lessor. When the requirements in IFRS 15 are not satisfied and the transfer is not a sale, IFRS 16 specifies that seller-lessees and buyer-lessors recognise all amounts to be paid or received as a financial liability or a financial asset. [Proposal by EFRAG Board member]

~~190~~207 EFRAG considers this approach to be prudent as no gain is recognised until the transaction satisfies the required conditions, and all liabilities arising in the course of the reporting period or of the previous period are recognised.

Overall conclusion on prudence

~~191~~208 EFRAG has concluded that:

(a) the recognition of liabilities arising from all lease contracts (with limited exceptions) is consistent with the concept of prudence;

~~(a)~~(b) the measurement of these lease liabilities leads to prudent accounting in that all payments that are not avoidable are included; regardless of whether they are fixed, in-substance fixed or variable lease payments that depend on an index or a rate;

~~(b)~~(c) the requirement to measure right-of use assets at cost less accumulated depreciation and impairment (with some exceptions) is aligned with the requirement applicable to owned property, plant and equipment, which have been assessed to lead to prudent accounting;

~~(c)~~(d) the use of fair value as the measurement basis for rights to use investment property and property, plant and equipment does not raise concerns about prudence; and

(e) for sale and leaseback transactions, IFRS 16 ensures that gains on sale and leaseback are only recognised, by the seller-lessee when a sale is realised whereas negative value adjustments are immediately provided ~~not overstated (nor losses understated) and~~for and that the carrying amount of the asset is not misstated by the buyer-lessor. [Proposal by EFRAG Board member]

~~192~~209 Consequently, EFRAG has concluded that the application of IFRS 16 would lead to prudent accounting.

True and fair view principle

~~193~~210 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~~ requires appropriate ~~all~~ disclosures that ~~are necessary to~~ provide a complete and reliable depiction of an entity's assets, liabilities, financial position, ~~and~~ profit or loss and cash flows.

Question to the EFRAG Board

One Board member proposes that paragraph 210 above be amended from the wording used in previous endorsement advices to read as follows. Should this change be made?

As mentioned previously (paragraphs 9 and 22) the Accounting Directive does not address specifically the topic of leases and/or the definition of a right-of-use and therefore neither encourages nor prohibits explicitly the recognition of leases as assets (directly or via right-of-use) and liabilities. However, the Directive, in its Article 6.1(h) and Recital 16 states that "the presentation of items in financial statements should have regard to the economic reality or commercial substance of the underlying transaction or arrangement". The key element of the "substance" of an operating lease (as defined under IFRS 16) is the right to control the use of the underlying asset, even if other features exist. EFRAG assesses that for IFRS financial statements such an emphasis is appropriate and does not contradict the Accounting Directive and therefore the true and fair view principle set in it. Moreover, EFRAG observes that IFRS 16 does 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.

~~194~~211 EFRAG assesses that, on a stand-alone basis, IFRS 16 provides relevant, reliable, comparable and understandable information and leads to prudent accounting. That is, the application of IFRS 16 provides information that is useful for decision-making and for assessing the stewardship of management.

~~195~~212 EFRAG also assesses that IFRS 16 does not create any negative interactions with other IFRS and is specifically designed to complement IFRS 15. Accordingly, EFRAG assesses that IFRS 16 does not lead to unavoidable distortions or significant omissions and therefore it does not impede financial statements from providing a true and fair view.

~~196~~213 EFRAG also concludes that IFRS 16 requires the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

~~197~~214 As a result, EFRAG concludes that the application of IFRS 16 would not lead to information that would be contrary to the true and fair view principle.

Overall Conclusion

~~198~~215 Accordingly, for the reasons set out above, EFRAG's assessment is that IFRS 16 meets the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether IFRS 16 is conducive to the European public good

Summary

Note to constituents

As explained in the note to constituents to this Preliminary Consultation Document, EFRAG has commissioned a study by an economic consultancy as an input to the final endorsement advice to the European Commission. This study is not complete at the time of publication of this Preliminary Consultation Document. When complete this study is expected to provide significant input into EFRAG's analysis of the impact of IFRS 16.

Paragraph 1 below is included to provide a summary of EFRAG's overall approach to assessing whether it would be conducive to the European public good to endorse IFRS 16. However, this assessment is incomplete at the time of publishing this Preliminary Consultation Document. The areas in which significant additional input is expected, and in which EFRAG's preliminary assessment is therefore incomplete, are identified at the start of each sub-section of this Appendix 3.

For this reason, this Appendix 3 does not provide an overall preliminary conclusion on EFRAG's assessment of European public good. Preliminary conclusions of certain aspects of the assessment are provided in areas where EFRAG has completed its preliminary assessment.

1 EFRAG considered whether it would be conducive to the European public good to endorse IFRS 16 *Leases*. In addition to its assessment included in Appendix 2, EFRAG has conducted an impact analysis, taking into consideration a number of specific issues, in order to identify whether the endorsement of IFRS 16 is expected to give rise to potential negative effects for the European economy. In doing this EFRAG:

(a) assessed whether IFRS 16 is an improvement over its predecessor IAS 17 across the areas which have been subject to changes;

(b) considered what impact IFRS 16 might have on the behaviour of preparers, investors and lenders and the impact of anticipated behavioural changes on the European economy;

(c) considered how IFRS 16 might impact the competitiveness of European undertakings, in particular because IFRS 16 and the equivalent US GAAP are not completely converged;

(d) considered the impact of IFRS 16 on the leasing industry

(e) considered the impact of IFRS 16 on SMEs;

(f) considered whether IFRS 16 is likely to endanger financial stability in Europe; and

(g) evaluated the costs and benefits of endorsing IFRS 16.

2 Additional effects may arise based on decisions made by Member States in the EEA to introduce changes in their local accounting principles or tax legislation. Appendix 3 includes the description of some of these potential additional effects. However, EFRAG did not consider these in its assessment because they are of the exclusive competence of Member States and EFRAG is not in a position to assess the likelihood of these changes.

Is the financial reporting required by IFRS 16 an improvement over that required by IAS 17?

3 EFRAG has focused its assessment of whether the financial reporting required by IFRS 16 is an improvement over that required by IAS 17 *Leases* on the areas of change it considers most significant.

Accounting by lessees

Recognition of a right-of-use asset and a lease liability for all leases

4 IFRS 16 eliminates the classification of leases as either operating or financing for a lessee. It introduces a single lessee accounting model whereby a lessee recognises assets and liabilities arising from all leases (with limited exceptions). This is the most significant change from IAS 17 in that it eliminates the distinction between finance leases (where lease assets and liabilities are recognised) and operating leases (where lease assets and liabilities are not recognised). This change is supplemented by additional guidance that will assist entities in consistently applying professional judgement.

5 This approach increases the relevance of information as it reflects in the primary financial statements the assets and liabilities that arise for lessees. It also provides a faithful representation of the economic substance of lease contracts, is not unduly complex to apply and understand, and addresses the criticism that operating lease assets and liabilities are not recognised on a lessee's statement of financial position. Consequently, IFRS 16 enhances the transparency of a lessee's financial leverage and reported assets, and thereby improves financial reporting. EFRAG assesses that with this information users will be able to better assess the financial position and financial performance of a lessee.

Presentation and disclosure

6 A consequence of a lessee recognising lease assets and liabilities is that it changes the presentation in the statement of profit or loss for leases that are classified as operating under IAS 17 (where the single line expense is included within operating costs). IFRS 16 requires the lease expense to be separated into interest expense (on the lease liability) within financing costs and depreciation expense (on the right-of-use asset) within operating costs. This change also affects the statement of cash flows with cash payments for the principal portion of the lease liability being classified as financing activities and cash payments for the interest portion being classified consistently with other interest payments (either operating or financing activities).

7 EFRAG considers that these requirements provide more relevant information than that provided by IAS 17 because there is cohesion in the recognition of the economic impact of the lease in the three primary financial statements. EFRAG assesses that this provide greater comparability between entities that borrow to buy assets and those that lease similar assets which will result in a more meaningful basis for users' analysis of financial statements.

8 Furthermore, a lessee is required to disclose a maturity analysis for lease liabilities by applying the requirements of IFRS 7 *Financial Instruments: Disclosures*. This requires a lessee to use judgement to determine the most relevant time bands whereas IAS 17 has prescriptive time bands. EFRAG assesses that this provides more relevant disclosures because the focus of the IFRS 7 approach is to provide information that will help users to understand a lessee's liquidity risk.

9 IFRS 16 also includes a disclosure objective so lessees will need to assess whether additional information is necessary to meet this objective. These requirements are likely to provide more relevant information to users because they are tailored to the lessee's specific portfolio of leases.

Adequacy of the guidance on all significant matters within its scope

10 As mentioned in Appendix 2, paragraph 145 in the assessment of the comparability criterion, IFRS 16 provides guidance on all of the most important issues covered in the previous guidance on leases and, in addition, provides extended application guidance on areas where the IAS 17 guidance was considered to be inadequate, including the definition of a lease; separating components of a contract; accounting for contract modifications; and variable consideration.

11 EFRAG assesses this to be an improvement that should result in IFRS 16 being applied more consistently than IAS 17.

Lessor accounting

12 Whilst IFRS 16 substantially carries forward the requirements in IAS 17 for lessors, it requires additional disclosures relating to how a lessor manages the risks associated with the rights it retains in the underlying assets and the risks associated with the lease payments receivable from the lessee. EFRAG assesses that this will provide users with more relevant information about a lessor's risk exposure.

~~12~~13 EFRAG notes that the lack of symmetry between lessor and lessee accounting may nonetheless add some complexity in relation to the accounting for intragroup leases, especially when a Group entity has an external lease and sub-leases the underlying asset to other entities in the Group. The issue is further discussed in paragraph 103 below.

Sale and leaseback transactions

~~13~~14 One of the consequences of the requirements in IFRS 16 is that it is likely that the nature of sale and leaseback transactions will be more appropriately depicted. Operating leases are not recognised under IAS 17, which gave the seller-lessee opportunities to obtain financing where associated liability was not recognised in the statement of financial position. Under IFRS 16, the seller-lessee will recognise all lease assets and lease liabilities (except in the unlikely event that the leaseback is eligible for the optional recognition exemptions). EFRAG assesses that this provides more relevant information through the recognition of financing provided to seller-lessees.

Key changes that may not be useful for users

~~14~~15 IFRS 16 introduces two optional recognition exemptions for short-term leases and leases of low-value assets. The use of these exemptions may limit the relevance of information because, in these cases, some lease assets and lease liabilities will not be recognised. There might also be some negative effect on comparability given that the use of the exemptions is optional.

~~15~~16 EFRAG however assesses that most short-term leases are likely to have been classified as operating leases under IAS 17 and therefore, the exemption is not deemed to result in a loss of information for users. The optional exclusion for leases of low-value assets has the potential to result in a loss of information, compared to IAS 17, when such leases are material in aggregate and were classified as finance leases under IAS 17.

~~16~~17 EFRAG acknowledges that these exemptions have been introduced to reduce the complexity and cost of IFRS 16 for lessees. To compensate for the lack of completeness in recognition, IFRS 16 requires the amount of expense to be disclosed.

Conclusion

~~17~~18 Based on the above analysis, EFRAG is of the view that IFRS 16 brings a significant improvement to the reporting of leases when compared with IAS 17.

Question to Constituents
Do you have any comments on the comparison of IFRS 16 with IAS 17?

Potential effects on stakeholders' behaviours

Note to constituents

EFRAG's is expecting to receive significant additional input into its assessment of the potential effects of IFRS 16 on stakeholders' behaviours. EFRAG's preliminary assessment is therefore incomplete and no preliminary conclusion is provided.

Approach to assessing the potential effects on stakeholders' behaviours

~~18~~19 As an input into the analysis of potential effects of IFRS 16 on stakeholders' behaviours, EFRAG has undertaken a study that considered the impact of the transition to IFRS 16 on the financial statements of a sample of entities listed on regulated markets. EFRAG has then considered:

(a) how these financial statement impacts might influence stakeholders' behaviours; and

(b) the possible consequences of potential changes in stakeholders' behaviours on other areas within the scope of our assessment of European public good.

Quantitative impact of IFRS 16 on financial statements

~~19~~20 EFRAG conducted a study[4] on the impact of applying IFRS 16 on European entities' financial statements. For practical reasons, the study was based on data drawn from 2014 financial statements.

~~20~~21 EFRAG selected a sample from a commercial database of large entities listed in Europe on the basis of market capitalisation or size of operating lease commitments. The sample includes 417 entities from nineteen countries, with a market capitalisation of 7.616 billion Euro.

~~21~~22 The simulation of the lease liability and right-of-use asset resulting from the application of IFRS 16 makes a number of assumptions on the timing distribution of the operating lease commitments, the discount rate, and the original and residual lease terms. For the baseline scenario, EFRAG used a discount rate of 5% (equal to the discount rate used by the IASB in its analysis of the accounting impact of IFRS 16), an original lease term of 8 years and a residual lease term of 5 years.

~~22~~23 The simulation is only illustrative and will not be identical to the effect of the initial application of IFRS 16 due to the following:

(a) The entities selected are a non-statistical sample, therefore the findings cannot be projected to the full population of IFRS preparers in Europe;

(b) The simulation is based on 2014 accounting data;

(c) The simulation applies a single set of assumptions to all leases without taking into account the specific individual terms;

(d) The simulation implicitly assumes that there are no new leases in the first period after initial application;

(e) IFRS 16 provides different elections for the first application. The simulation assumes that the entities will apply the approach described in paragraph C8(b)(i) in the Standard, which results in an impact on equity on initial application. The use of different elections in the transition requirements would result in a different measurement of the right-of-use asset, a different simulated impact on equity on initial application and a different simulated impact on profit or loss in the first period after initial application.

4 See EFRAG Secretariat paper *IFRS 16: Quantitative assessment of accounting impact.*

~~23~~24 Based on these assumptions, the quantitative impact of applying IFRS 16 in 2014 would have been to:

(a) create a lease liability of 450.9 billion euro, representing 4% of the item 'total debt' as defined in the commercial database, and 1.3% of the total liabilities (calculated as the difference between total assets and equity). When entities in Financials industry are excluded, the lease liability represents 16% of the total debt;

(b) create a right-of-use asset of 420.7 billion euro representing 14.8% of net property, plant and equipment;

(c) impact equity by 30.2 billion euro, representing 0.6% of the equity;

(d) introduce a lease expense for the following period of 106.7 billion euro, which is 1.8 billion euro lower than the lease commitments due within 12 months and represents 0.3% of income before taxes;

(e) increase EBITDA, excluding the Financials industry, by 10.2%. The impact on EBT and EBITDA is highly sensitive to the lease term assumptions, as the simulated right-of-use asset is amortised on the assumed residual lease term.

~~24~~25 Other observations from the study are that:

(a) IFRS 16 impacts industries differently with the greatest impact in terms of the lease liability as a percentage of total debt being energy, technology and consumer staples and the least affected being materials, utilities and financials;

(b) the lease liability represents 8.7 times the amount of finance capital leases liability (450.9 billion to 52 billion euro), indicating the relative magnitude of finance and operating leases under IAS 17; and

(c) the commercial database discloses a metric called 'Operating lease debt equivalent' equal to eight times the rental expense for the year. This metric amounts 786.6 billion Euro for the sample, 74% higher than the lease liability from the study.

~~25~~26 EFRAG performed a sensitivity analysis of the impact of changes in the discount rate:

(a) the impact on the lease liability and right-of-use asset are sensitive to the selection of the discount rate, but the sensitivity is not so great that the overall results noted above cannot be taken as an indication; and

(b) the impact on earnings before taxes is not significantly sensitive to changes in the discount rate.

~~26~~27 A second part of the study considered the impact of IFRS 16 on a sample of listed and unlisted small and medium entities using IFRS. The sample includes 487 entities from twenty countries. Given the limited availability of data on unlisted SMEs using IFRS in the commercial data base, this sample may not be representative of SMEs overall limited.

~~27~~28 The results from the study are:

(a) the lease liability amounts to 817.7 million euro, representing 2.9% of total debt. However, the sample includes three finance companies that report very high debt (77% of the total sample), and 158 entities for which the net debt is zero. When these finance companies are excluded, the ratio rises to 9.8%;

(b) the right-of-use asset amounts to 763 million euro, representing 13.3% of property, plant and equipment; and

(c) the difference between the lease liability and right-of-use asset of 54.8 million euro represents 0.3% of equity.

~~28~~29 The conclusions that can be drawn from the study are:

(a) the lease liability and the right-of-use asset created on transition to IFRS 16 may have a material, but not overwhelming, effect on entities' financial statements;

(b) the impact on the samples of large listed entities and listed and unlisted SMEs are not dissimilar; and

(c) the practice by some users of estimating the lease liability by applying a factor of 8 to operating lease cash flows overestimates the lease liability, which confirms the findings of the IASB Effects Analysis.

Impact of financial statement changes on behaviour of users

~~29~~30 Academic studies support the view that many users currently adjust reported balance sheet figures to capitalise operating leases. There is evidence, especially from studies conducted in the US, that credit spreads on new loans, bond ratings and spreads in credit default swaps are all correlated to the amounts of leases commitments. However, the observed correlation is weaker than the correlation with finance debt. Some studies conclude that this proves that sophisticated users like banks consider operating leases differently from debt5. Others argue that this proves that current information on operating leases is insufficient and capitalisation would improve the investors' decisions[6].

~~30~~31 Users have repeatedly supported capitalisation of leases. A 2013 survey of 288 global users[7] had 73% of respondents agreeing that it would result in more comparability across entities, 72% of respondents agreeing that it would result in reduced analyst adjustments and 68% of respondents agreeing that it would result in greater accuracy in analysis and decision-making. However, only 33% of the respondents (and 24% from the EEA region) agreed that it would lower the cost of capital.

~~31~~32 During its due process, the IASB received significant support on lease capitalisation from users. Eleven comment letters from them were submitted on the 2013 Exposure Draft from users' organisations, out of the total 641. Ten of the respondents supported capitalisation of leases, although there were different views on whether there should be one or two cost recognition patterns and on measurement requirements.

33 There is evidence that credit rating agencies adjust for lease commitments that are not recognised. One agency indicates for instance that their approach is to capitalise operating leases with the aim of bringing companies' ratios closer to the underlying economics and take consideration of all their financial obligations, whether or not on the balance sheets. The methodology used attempts to capture only a debt-equivalent for a company's lease contracts.

~~32~~34 In its outreaches with users[8], EFRAG has become aware that users may continue to adjust the information reported in financial statements. However, users generally have advised that IFRS 16 provides a better starting point for their analyses than IAS 17.

[5] Altamuro, Johnston, Pandit and Zhang (2012), *Operating leases and credit assessment.*

[6] Cotton, Schneider and McCarthy (2013), *Capitalisation of operating leases and credit ratings.*

[7] CFA Institute (2013), *Lease accounting survey report*

[8] See, for example, the summary event report on the user outreach EFRAG, EFFAS and ABAF/BVFA "What is new in Accounting for Leases: a change worth $2.2 trillion" **here**

Questions to constituents
Do you have any views or information on how IFRS 16 can be expected to affect the behaviour of investors and/or lenders?
If so, do you have any views or information on whether and how IFRS 16 could, for European companies that apply IFRS, positively or negatively affect:
(i) the overall cost of capital;
(ii) access to finance and cost of credit?
Please provide any available evidence.

Impact of financial statement changes on behaviour of lessees

Use of leases

~~33~~35 The use of leases is widespread in Europe. In 2013[9], EU enterprises in the business of 'renting or operating own or leased real estate' generated a turnover of 296.7 billion euro, and EU enterprises in the business of 'rental and leasing' generated a turnover of 149.7 billion euro. The enterprises in these sectors employed approximately 2 million employees.

~~34~~36 Entities use leases for different reasons. Currently, payments under an operating lease are recognised as an expense over the lease term. Some entities that currently lease assets may decide that they have less incentive to lease: if their primary purpose for leasing was the accounting treatment of operating leases ~~accounting treatment of all leases is aligned to the treatment of purchases~~ and lessees are required to capitalise all leases under IFRS 16, there may be less incentive for these entities to lease. As a consequence, these entities could stop leasing and seek to acquire their assets through other means such as borrowing to purchase ~~assets with a loan~~.

~~35~~37 It is not possible to provide a quantitative assessment of this potential effect. However, EFRAG notes that there are a number of reasons why entities would continue leasing.

(a) Leases provide advantages regardless of their accounting treatment. Leases offer more operational flexibility (for example, they allow the lessee to adapt the length of a contract to suit a specific need) and do not expose the entity to any risk associated with the residual value of the assets. Lessors often provide additional services, and payments based on usage are more common than variable payments for purchases of similar assets. In some cases, tax rules related to leases may be more advantageous for lessees.

(b) Although IFRS 16 requires the recognition of a lease liability for all leases, its measurement is based on the payments due over the lease term and not on the fair value of the underlying asset. In general terms, an entity that leases an asset for less than its economic life would recognise a liability for an amount lower than the liability that would be incurred to purchase the asset.

(c) Thirdly, the leasing industry could react by continuing to innovate~~ing~~ its business model. Entities are moving away from 'plain vanilla' leases and are requesting more comprehensive asset solutions that meet both their financial needs and operational requirements in one packaged product. More innovation from lessors would further differentiate leases from purchase transactions, even to the extent that entities gain access to the benefits that can be provided

[9] Source: Eurostat.

by assets through a service contract rather than a lease. EFRAG anticipates that such innovations that meet business needs will result in ~~with the effect that~~ the choice between a service, leasing or buying ~~is~~ being based mostly on business reasons with relatively little consideration of the accounting outcome. [To address an issue raised by a Board member]

~~36~~38 There is limited material on expected changes in lessees' behaviour. In a 2013 global survey of CFA Institute members with an interest in financial statement analysis[10], over 60% expressed the view that entities would continue to engage in leasing transactions regardless of any requirement to capitalise operating leases. In another survey among European SMEs, respondents rated pricing as the most important reason to lease; accounting benefits were in fifth place, while lack of exposure to residual value and reduced need for collaterals scored relatively low.

Impact on lease term

~~37~~39 Since the measurement of the lease liability is based on the present value of the payments due over the lease term, it is possible that lessees will ask for shorter lease terms and more frequent inclusion of options to extend or break clauses. Another possibility is that lessees will want to replace fixed payments with more variable lease payments, which the lessee recognises only when they become due (with the exception of payments that depend on an index or rate).

~~38~~40 Shortening the length of lease contracts exposes lessors to a higher residual value risk and it is possible that lessors will ask for compensation through increased lease payments. Market values of second-hand underlying assets could be adversely impacted as well. On the other hand, shortening the length of the lease term, may have negative impacts on lessees. For example, lease payments per period may rise to compensate the lessor for the increased residual risk, lessees will be exposed to the risk that their use of leased assets is less secure given the potential for the lessor to re-lease the assets to others, or their desired assets may not be available given demand from other parties. Where this applies, lessees may seek longer lease terms to ensure supply (and possibly get more favourable rates) as there is no recognition impact of the lease term (other than for short-term leases). [To address an issue raised by EFRAG Board member]

Question to constituents

Do you have a views or information on how IFRS 16 might affect companies' use of leasing? For example, do you expect lessees to:

(i) reduce their use of leases with a corresponding increase in purchases of assets;

(ii) reduce their use of leases without a corresponding increase in purchases of assets;

(iii) seek to change the terms of new of existing leases to reduce the accounting impact?

Please provide any available evidence.

[10] Source: *Lease accounting survey report* CFA Institute

Impact of IFRS 16 on the leasing industry

Note to constituents

EFRAG's is expecting to receive significant additional input into its assessment of the Impact of IFRS 16 on the leasing industry. EFRAG's preliminary assessment is therefore incomplete and no preliminary conclusion is provided.

Approach to assessing the impact of IFRS 16 on the leasing industry

~~39~~41 EFRAG has asked the economic consultancy to identify existing trends in the leasing industry in terms of offerings of leases and services. EFRAG is also gathering evidence on how the leasing industry funds its leasing activities.

~~40~~42 EFRAG will be using the report from the economic consultancy relating to stakeholder behaviours to assess whether any expected changes in behaviours are likely to affect the demand for leases. This will be reviewed in the light of existing trends to try to identify whether the expected changes in behaviours are likely to change the existing trends.

Question to constituents

Do you have any information or views on how the endorsement of IFRS 16 can be expected to affect the leasing industry in Europe?

Please provide any available evidence.

Impact of IFRS 16 on SMEs

Note to constituents

EFRAG's is expecting to receive significant additional input into its assessment of the potential effects of IFRS 16 on SMEs. EFRAG's preliminary assessment is therefore incomplete and no preliminary conclusion is provided.

Approach to assessing the impact of IFRS 16 on SMEs

~~41~~43 EFRAG is approaching its assessment of the impact of IFRS 16 from two perspectives,

~~42~~44 In terms of the impact of IFRS 16 on SMEs applying IFRS, EFRAG is seeking information from Member States and other sources to identify the extent to which SMEs apply IFRS under various Member States' options in the IAS Regulation. Preliminary indications are that few unlisted SMEs are applying IFRS.

~~43~~45 If it were to become apparent that a significant number of unlisted SMEs are applying IFRS in certain jurisdictions, EFRAG will review a sample of financial statements to identify the significance of leasing in the funding mix of those SMEs in order to assess, given the stakeholders behaviours identified above, whether there will be any impact on SMEs that is different from the overall impact on other entities.

~~44~~46 The second perspective will be to take any likely impact on the leasing industry to consider whether there will be a flow on to SMEs, regardless of the accounting standards that they apply. As an extreme example, if IFRS 16 were to have such an impact on the leasing industry that leasing became effectively unavailable, this would affect all SMEs who have difficulty in financing the assets they require for business purposes through sources other than leasing.

Question to constituents

Do you have any information or views on how the endorsement of IFRS 16 can be expected to affect the leasing industry in Europe?

Please provide any available evidence.

Is IFRS 16 is likely to endanger financial stability in Europe?

Note to constituents

EFRAG's is expecting to receive significant additional input into its assessment of the whether IFRS 16 is likely to endanger financial stability in Europe on stakeholders' behaviours. EFRAG's preliminary assessment is therefore incomplete and no preliminary conclusion is provided.

Approach to assessing whether IFRS 16 is likely to endanger financial stability

~~45~~47 EFRAG is consulting with the ECB as to its views as to whether IFRS 16 is likely to endanger financial stability in Europe. It is also seeking views from constituents.

Question to constituents

Do you have any information or views on whether IFRS 16 is likely to endanger financial stability in Europe?

Please provide any available evidence.

Potential effects on competitiveness

Lack of full convergence between IFRS 16 and the equivalent US GAAP pronouncement

~~46~~48 In February 2016, the FASB issued Accounting Standards Update *Leases* (Topic 842) that introduces new accounting requirements for entities reporting leases under US GAAP.

~~47~~49 In many respects, the requirements in IFRS 16 and US GAAP are the same. In particular, the two Standards are mostly converged in relation to:

(a) identifying if a contract is, or contains a lease;

(b) recognition of right-of-use assets and lease liabilities (except that Topic 842 does not include an exemption for leases of items of small value);

(c) initial measurement of right-of-use assets and lease liabilities; and

(d) subsequent measurement of lease liabilities.

~~48~~50 However, IFRS 16 and IAS 17 are not aligned in some other areas. EFRAG has considered if the lack of convergence between the two Standards may result in European entities being at a competitive disadvantage.

Expense recognition pattern

~~49~~51 In Topic 842, leases continue to be classified as either finance and operating, with the distinction being made on the basis of the principle and criteria used in IAS 17. Despite retaining the distinction between finance and operating leases, US GAAP requires lessees to recognise right-of-use assets and lease liabilities for both categories. The initial measurement is the same, but subsequent measurement of right-of-use assets differs depending on the classification of the lease.

~~50~~52 For finance leases, the lessee applies the same treatment as under IFRS 16. For operating leases, the lessee recognises a single lease expense which is presented as a single amount in operating costs. In most cases, the expense is expected to result in a constant charge over the lease term, when variable payments are not taken into consideration.

~~51~~53 Therefore, both an IFRS preparer and a US GAAP preparer would report the same total cost over the lease term, but for operating leases the pattern of recognition of the cost during the term will be different, with the IFRS preparer recognising a higher total cost at the beginning of the term of new leases ~~in early periods~~ than under US GAAP.

~~52~~54 The impact of the different cost recognition pattern on profit or loss depends on the number and amount of operating leases, their length and the discount rate applied. As an example, for a 10-year term and a 6% discount rate, the maximum cumulative difference would be at the end of the fifth year when the IFRS preparer would have recognised 55% of the total cost (versus 50% for the US GAAP preparer); for a 15-year term and a 4% discount rate, the maximum cumulative difference would be at the end of the eighth year, when the IFRS preparer would have recognised 59% of the total cost (versus 53% for the US GAAP preparer).

~~53~~55 In any given year, the impact on the profit or loss could be positive or negative depending on the average original and residual lease term. In general, an IFRS preparer will report during the lease term:

(a) lower equity; and

(b) higher EBITDA and EBIT, because part of the cost will be presented as an interest charge.

~~54~~56 When companies hold a portfolio of leases, typically some leases will be in the early period and some will be in the late period of their terms. The cumulative difference in the lease expense recognised in a given period by an entity applying IFRS 16 and an entity applying Topic 842 will then be mitigated by the portfolio effect. This is ~~,~~ because the entity applying IFRS 16 will recognise a higher lease expense for the leases that are early in their terms and a lower lease expense for those that are far into their terms.

Presentation of lease liabilities

~~55~~57 Neither IFRS nor US GAAP have a definition of 'debt' and neither Board has explicitly indicated what the nature of the lease liability is. Despite this lack of definition, IFRS 16 and US GAAP have slightly different presentation requirements for lease liabilities.

(a) Under IFRS 16, a lessee presents lease liabilities separately either in the statement of financial position or in the notes. In the case of presentation in the notes, IFRS 16 requires the line items in which the lease liabilities are included to be identified.

(b) Under US GAAP, liabilities arising from operating and finance leases are presented separately in the statement of financial position or included in another line item (but not the same line item), with indication of the relevant line item in the notes.

~~56~~58 By requiring separate presentation of the liabilities arising from operating and finance leases, US GAAP makes it possible for users to assess and treat lease liabilities arising from operating and finance leases differently when calculating ratios. However, under both US GAAP and IFRS, entities need to separate the short-term and long-term portion of their lease liabilities. If the 'working capital' metric is calculated based on current assets and liabilities, under US GAAP, short-term operating lease liabilities would be part of the calculation. Under IFRS 16, either all short-term lease liabilities or none would be included depending on the ~~analyst's~~ preparer's view of whether lease liabilities are financial or non-financial in nature.

~~57~~59 Furthermore, the decisions of the US Securities and Exchange Commission could also influence practice. Currently, paragraph 5.22 of Regulation S-X requires industrial and commercial entities to present capitalised leases, under the heading long-term debt, together with bonds, mortgages and other long-term debt.

~~58~~60 In contrast, under IFRS 16, separate presentation of lease liabilities arising from former "operating" and former "finance" leases is not required. However, separate identification and presentation ~~it~~ is not prohibited. A decision to separate the total amount of lease liabilities according to the US GAAP classification is subject to two considerations:

(a) IAS 1 requires that line items are disaggregated when this is relevant to an understanding of the entity's financial position. It is possible that the relevance of any disaggregation of the lease liabilities could be challenged. Furthermore, IAS 7 requires a reconciliation of items of the statement of financial position for which cash flows are classified under financing activities which will include lease liability (or liabilities if the lease liability is separated); and

(b) An entity would voluntarily incur costs in applying the US GAAP classification test and would not benefit from one of the advantages of the IASB approach in terms of cost. It is likely that such a separation would only be undertaken if the benefits of separation of lease contracts into two categories were expected to exceed the costs.

~~59~~61 One argument used by the FASB to justify the separate presentation of the two types of lease liabilities is that their treatment is different in US bankruptcy law. EFRAG does not consider that this approach is appropriate for IFRS 16. Firstly, it is arguable whether presentation based on the treatment in bankruptcy is appropriate for use in a principles-based standard. Further, European and other non-US insolvency laws may not make a distinction between different types of leases or may make a distinction on a different basis.

Ongoing application costs

~~60~~62 EFRAG notes that there is disagreement about whether US GAAP or IFRS 16 would be more costly to apply. Some consider that IFRS 16 would be more costly to apply because US GAAP retains the straight-line lease expense as applied today and the right-of-use asset can be calculated directly from the lease liability. Others consider that the dual model in US GAAP could be more costly to apply on an ongoing basis because:

(a) IFRS 16 removes the IAS 17 classification test between operating and finance leases which will still be required under US GAAP;

(b) under US GAAP, entities will not be able to use their existing fixed asset systems for right-of-use assets of operating leases because the depreciation charge is determined as the algebraic difference between a constant lease expense and the interest charge on the lease liability. In most cases, this results in an annuity method of depreciation that is not applied to any other asset and would not generally represent the consumption of the benefits embodied in the asset; and

(c) Topic 842 does not include an exemption for leases of items of low value.

~~61~~63 Topic 842 does not require preparers to reassess the lease liability where there is a change in future payments resulting from a change in an index or a rate used to determine those payments. The FASB argues that this results in lower ongoing costs for those preparers that have leases with such indexation clauses, but this view ignores the need to separate lease payments between those related to the lease liability and those expensed in the reporting period.

Conclusion

~~62~~64 The impact of applying IFRS 16 or Topic 842 on financial position and performance is mixed. EFRAG's analysis is that implementation costs may be slightly lower for IFRS preparers in some areas and slightly higher in others, but that the overall new difference should not be significant. Overall EFRAG does not consider that the lack of full convergence between the two Standards will put IFRS preparers at a competitive disadvantage.

Question for constituents

Do you have any evidence as to the relative costs of applying IFRS 16 and US GAAP? Do you have any other views as to the advantages or disadvantages of IFRS 16 compared to US GAAP?

Costs and benefits of applying IFRS 16

Note to constituents

EFRAG's is expecting to receive significant additional input into its assessment of the costs and benefits of applying IFRS 16. EFRAG's preliminary assessment is therefore incomplete and no preliminary conclusion is provided.

Introduction

~~63~~65 EFRAG has considered the extent to which implementing IFRS 16 in the EU will result in incremental costs for preparers and/or users, and whether these costs are likely to be exceeded by the benefits to be derived from the endorsement of IFRS 16. This assessment considers both year one and subsequent years.

~~64~~66 The approach that EFRAG has endorsed has been to carry out detailed initial assessments of the likely costs and benefits of implementing IFRS 16 in the EU, to consult on the results of those initial assessments, and to finalise those assessments in light of the comments received.

Costs for preparers

~~65~~67 EFRAG has carried out an assessment of the costs for preparers resulting from the application of IFRS 16.

~~66~~68 As IFRS 16 carries forward most of the existing requirements for lessor accounting, EFRAG has focussed on the assessment of costs from the perspective of lessees. EFRAG expects that the costs for lessors of applying IFRS 16 will be low because the changes in IFRS 16 to lessor accounting has a relatively minor impact.

~~67~~69 In IFRS 16, the IASB has sought to reduce the cost of transition for preparers by providing options, exemptions and practical expedients. Some of these are accounting policy choices, some apply by class of underlying assets and some can be elected on a lease-by-lease basis. This results in multiple possible ways to transition to IFRS 16 and the choice of the transition methods will have a major impact on the cost of implementation.

~~68~~70 This range of options makes it difficult to provide a general assessment of the cost of transitioning to IFRS 16. For instance, the practical expedient allowing an entity to 'grandfather' the definition of a lease for contracts entered into before the effective date of IFRS 16 may provide ~~considerable~~ significant relief upon transition as entities will not be required to reassess whether their existing contracts are or contain a lease. Similarly, under the modified retrospective approach, a lessee will not restate information for comparative periods and will be allowed to use practical expedients for the initial measurement of right-of-use assets and lease liabilities.

~~69~~71 EFRAG expects that, when entities make their decisions about using the simplifications, they will consider whether the perceived benefits of a fuller reassessment are expected to be higher than the related costs.

One-off costs

Understanding IFRS 16 and selecting accounting policy choices

~~70~~72 Entities will initially need to incur the costs of reading and understanding IFRS 16. Some of these costs will be incurred before the endorsement of IFRS 16 either by the entities themselves or by their advisors. Based on this understanding, the application of IFRS 16 will require decisions about the selection of accounting policies such as when to apply practical expedients. These accounting policy choices will need to be documented and considered throughout the processes associated with implementing and applying IFRS 16.

Systems and controls

~~71~~73 The one-off costs for lessees will depend on a number of factors including:

(a) whether the entity already is a party to finance leases and, if so, the ease with which the supporting systems and controls can be extended to cater for the requirements of IFRS 16 relating to operating leases; and

(b) the sophistication of an entity's existing systems and controls relating to the accounting for and management of leases, and systems and controls for property, plant and equipment and financial liabilities.

SYSTEM CHANGES

~~72~~74 System changes may be required to capture the data necessary to comply with the new requirements including creating an inventory of all leases upon transition. This will include collecting:

(a) additional information needed to separate lease and non-lease components (this is already, to a large extent, required under existing standards);

(b) information about lease extension and termination options, and purchase options;

(c) information related to variable lease payments linked to indexes or rates; and

(d) information needed for disclosures.

~~73~~75 Entities that have a decentralised lease administration system, for example a system in which leases are administered at individual business units or geographic locations, may face additional costs if they decide to centralise their operations. Similarly, where existing databases (whether centralised or decentralised) have limited capacity and functionality costs may be incurred to make the necessary enhancements.

~~74~~76 If suitable systems do not already exist, systems will need to be developed or enhanced to measure lease liabilities at amortised cost and right-of-use assets at cost less depreciation and impairment. For instance, entities may need to develop new databases to store information on leases, and to supplement existing systems in order to facilitate the production of information required by IFRS 16.

~~75~~77 Similarly, lessees that do not have a separate procurement processes for leases (distinct from other accounts payable) may have to incur costs to identify and capture the information required by IFRS 16, and to implement appropriate controls.

~~76~~78 Entities that already have well-organised lease administration and accounting functions may still need to evaluate whether their existing systems, policies, processes and controls require adjustments to accommodate the changes required by IFRS 16. Where existing systems do not have the capability to provide the necessary information, significant effort could be required to manually gather missing lease information. Entities with less sophisticated systems are likely to incur more significant costs when implementing or upgrading their IT systems.

SET UP PROCESSES AND CONTROLS

~~77~~79 Lessees will need to consider the related processes and internal controls that will be necessary to gather lease contract data, make required estimates and provide the required disclosures. This includes extracting, gathering and validating lease data.

~~78~~80 Extracting lease data from lease contracts that currently is not systematised, and/or collecting lease data from different operational or other systems, may prove costly. Once data is gathered and migrated from various sources it will need to be validated. The practical implications of validating lease data may require significant resources.

~~79~~81 In its assessment, EFRAG has considered the following major processes:

(a) additional processes for identifying if a contract is, or contains, a lease (this is already required under existing standards);

(b) additional processes for separating lease and non-lease components in a contract (this is already required under existing standards); and

(c) collecting the additional historical information needed to first apply the requirements in IFRS 16;

~~80~~82 *Process to identify if a contract is, or contains, a lease*. Upon transition to IFRS 16, both lessees and lessors will not be required to reassess whether a contract, entered into before the effective date, is or contains a lease. Accordingly, an entity is expected to incur costs in identifying leases within existing contracts only when it chooses to reassess those contracts (most likely in situation where the entity expects the benefits of the reassessment to outweigh the related costs). However, entities that already have leases will have processes to make this determination and may need to enhance them.

83 As mentioned in paragraph 133 of Appendix 2, EFRAG has conducted specific fieldwork with a number of preparers, on the complexity of determining whether a contract is a lease. Participants in that field test found that identifying whether a contract contained a lease did not require exceptional judgement.

~~81~~84 *Process to separate lease and non-lease components.* Similar to IAS 17, IFRS 16 requires entities to separate lease and service components of a contract. However, EFRAG notes that the separation into components will become more important when applying IFRS 16 because of the differences in accounting for leases formerly classified as operating leases and services. As a result, entities will have to spend more resources to assess the different components of a contract than required by IAS 17.

~~82~~85 However, EFRAG observes that cost may be mitigated by using the practical expedient available for lessees allowing them to elect not to separate non-lease from lease components and instead account for them as a single lease.

~~83~~86 *Process to collect the additional information needed to first apply the requirements in IFRS 16.* Once an entity's systems and processes are in place, EFRAG expects incremental one-off costs only in relation to the additional information needed to first apply the requirements in IFRS 16.

~~84~~87 For simple lease agreements, the information required to apply IFRS 16 would be similar to that required to apply IAS 17. EFRAG anticipates that lessees would already have some form of inventory of leases, and information about lease terms and future lease payments, in order to provide the disclosures required by IAS 17. However, EFRAG observes that the first implementation of IFRS 16 will require additional information in relation to:

(a) discounting lease liabilities; and

(b) identifying leases with variable payments that are based on indices or rates (for measurement purposes) and those that are based on other factors (for disclosure purposes).

~~85~~88 EFRAG assesses that costs will be incurred by lessees in relation to the determination of the discount rates to be applied to each lease currently classified as an operating lease under IAS 17. However, EFRAG observes that, upon transition, such costs will be mitigated by:

(a) the requirement for lessees, to use their incremental borrowing rate (rather than the rate implicit in each lease contract) to determine the present value of the remaining lease payments; and

(b) the practical expedient allowing the use of a single discount rate to a portfolio of leases with 'reasonably similar characteristics'.

OTHER PROCESSES

~~86~~89 EFRAG has also considered the potential indirect effect of IFRS 16 on administrative and support processes other than lease administration. Because IFRS 16 will affect reported performance, entities will also need to consider the effect of changes to any processes that reference reported performance such as their remuneration schemes and staff bonuses. They may also need to determine necessary changes to tax-related processes. Any changes may affect system requirements, and further complicate processes and controls. The associated costs are however expected to vary by jurisdiction based on local requirements.

~~87~~90 Lastly, some entities may have to renegotiate their existing financing arrangements and loan covenants. During the outreach conducted by EFRAG, some lenders have indicated that they do expect to renegotiate covenants either on a contractual or voluntary basis. Some lessees may therefore incur additional costs associated with the renegotiation of their existing financing arrangements.

COMMUNICATION AND STAFF EDUCATION

~~88~~91 Entities will need to update their policies and manuals, as well as to provide education on the application of IFRS 16, in order to ensure consistency around areas of judgement.

~~89~~92 The type and volume of leased assets and the complexity of lease agreements differ significantly between entities and across industries. EFRAG assesses that education and training costs for entities with larger and more complex lease portfolios will be relatively higher than for those with simpler arrangements. Those costs are expected to be less significant for entities that have finance leases under IAS 17 as such entities are likely to already have some procedures in place.

~~90~~93 Communication costs are likely to be incurred when explaining the significant changes to external parties such as investors and lenders. EFRAG observes that those communication costs will be related to explaining the effect on the financial information reported by the entity, which may include explaining the changed accounting for leases.

Ongoing costs

~~91~~94 Once an entity has updated its systems to provide the information required by IFRS 16, EFRAG expects incremental ongoing costs to be mainly related to collecting the data required to implement IFRS 16 at each reporting date. EFRAG assesses that this data is similar to that needed to provide note disclosures for operating leases under IAS 17, with the exception of the following:

(a) discounting lease payment obligations for new or modified contracts;

~~(a)~~(b) carrying the right-of-use assets at cost less depreciation and impairment;

(c) remeasuring the lease liability under certain circumstances;

~~(b)~~(d) consolidating intra-group leases; and

~~(c)~~(e) providing the additional disclosures required by IFRS 16.

~~92~~95 EFRAG expects that the exemptions for short-term leases and leases of low-value assets will reduce the costs in the above areas.

DISCOUNTING LEASE PAYMENT OBLIGATIONS

~~93~~96 EFRAG assesses that the requirement in IFRS 16 to discount lease obligations for each new and modified lease contract is likely to increase ongoing costs for lessees compared to current IFRS for lease contracts classified as operating under IAS 17.

~~94~~97 The interest rate implicit in a lease may not be explicitly stated in the agreement and its determination by the lessee would require information such as the fair value of the leased asset and the initial direct costs incurred by the lessor. EFRAG considers that some of this information might not be readily available, although some of the information will have been considered when deciding whether to enter into a lease.

~~95~~98 EFRAG however observes that when the interest rate implicit in a lease is not readily determinable, costs are reduced for the lessee by requiring the use of the entity's incremental borrowing rate.

CARRYING THE RIGHT-OF-USE ASSETS AT COST LESS DEPRECIATION AND IMPAIRMENT

99 Ongoing cost may be incurred by preparers to subsequently measure right-of-use assets at cost less depreciation and impairment at each reporting date. Although the requirements are similar to those already applicable for Property, Plant and Equipment under IAS 16, costs may also be driven by the volume of leases involved and by the frequency of remeasurements occurring on the lease assets and liabilities. [Based on comment from EFRAG Board member]

REMEASURING THE LEASE LIABILITY

~~96~~100 EFRAG has considered two instances which might require a lessee to remeasure its lease liabilities and right-of-use assets, with a consequential impact on costs. These are where the lease contract contains:

(a) extension and termination options; or

(b) lease payments that are linked to an index or rate (e.g. inflation).

~~97~~101 EFRAG is of the view that, even when a lease contains options to extend or terminate the lease, the remeasurement of the lease liability is unlikely to be onerous because the threshold for reassessment is relatively high. IFRS 16 restricts the reassessment of the lease term after its initial determination to 'significant changes in circumstances' that are within the control of the lessee.

102 EFRAG expects that costs of remeasuring lease liabilities will arise mainly in relation to leases for which payments are linked to an index or rate. However, EFRAG observes that IFRS 16 requires such a reassessment only when there is a contractual change in the cash flows; that is, when the change in the inflation rate or index 'resets' the cash flows, rather than at each reporting date. The significance of the costs incurred will also depend on the frequency of the change in payments, the number of contracts affected and the accounting system in place to manage those contracts.

CONSOLIDATING ~~F~~ INTRA-GROUP LEASES

103 EFRAG is aware of cases where a Group entity secures a main lease from a third party and then sub-leases the underlying asset to other entities in the Group for shorter durations. When the terms of the main lease and the sub-lease differ significantly, the intermediate lessor treats the sub-lease as an operating lease and does not derecognise the right-of-use asset.

~~98~~104 In this scenario, the intragroup lease liability recognised by the sub-lessee cannot be eliminated against a corresponding intragroup lease receivable. At the consolidated level, the lease liability will need to be offset against the right-of-use asset, amortisation of the right-of-use and interest expense on the sub-lease together with the intragroup operating lease income. Consolidation software may need to be adapted to deal with this entry, or the entity may need to resort to manual adjustments.

PROVIDING DISCLOSURES REQUIRED BY THE STANDARD

~~99~~105 The costs of applying the lessee disclosure requirements in IFRS 16 will depend on an entity's lease portfolio. It is expected that the costs be incurred by entities will increase as their lease contracts become more complex.

~~100~~106 For leases that contain complex features (for example, variable lease payments, extension options and residual value guarantees), IFRS 16 requires disclosure of material entity-specific information to the extent it is not already required by another standard. This information is expected to differ between entities and judgement will need to be applied to determine the extent of the disclosures.

~~101~~107 For entities with 'simple' leases, it is likely that most of the information to be disclosed can be derived with little ongoing cost. In that case, the expected effect on cost will only be marginally different from costs incurred when applying IAS 17.

COST MITIGATION DUE TO EXEMPTIONS AND PRACTICAL EXPEDIENTS

~~102~~108 As explained in paragraph 94 above, EFRAG expects the main ongoing costs to arise from gathering that data on a timely basis so that lease assets and liabilities are recognised and disclosures are made at each reporting date.

~~103~~109 In its assessment, EFRAG has therefore considered the effects on costs of a number of exemptions and practical expedients permitting, in particular, lessees to not recognise assets and liabilities for short-term leases and leases of low-value assets and to not separate non-lease components from lease components.

~~104~~110 As mentioned in paragraph 71, above, it is expected that when entities make their decisions about using the simplifications, they will consider whether the perceived benefits of a fuller reassessment are expected to be higher than the related costs. Based on the fieldwork conducted during the development of IFRS 16, EFRAG is of the view that the exemption for short-term leases has the potential to provide substantial cost reliefs for potentially high volumes of leases.

~~105~~111 The exemption for leases of low-value assets is expected to provide cost relief, especially to smaller entities with relatively large portfolios of low-value assets. For larger entities for which leases of low‑value assets would often be immaterial even in aggregate, the relief provided will not be so great and the exemption is not expected, in many cases, to have an effect on reported figures.

~~106~~112 The option to not separate lease and non-lease components is expected to reduce costs for some lessees. In particular, it is expected to be used when the non-lease component is small or even immaterial. It is also possible that a lessee will prefer to present non-lease costs within leasing depreciation and interest rather than separately as better reflecting their view of a lease. [Proposal by EFRAG Board member]~~This is because the practical expedient results in increased lease liabilities~~.

Conclusion – costs for preparers

~~107~~113 Overall, EFRAG's assessment is that the cost of implementing IFRS 16 is likely to be more significant for lessees with a significant number of operating leases under IAS 17. However, the significance of the cost will vary depending on the size of an entity's lease portfolio, the terms and conditions of those leases and the systems already in place to account for leases applying IAS 17. As noted above, EFRAG does not expect lessors to incur significant costs.

Question to Constituents

What is your view on the one-off and ongoing costs for preparers?

Will preparers that already report finance leases have lower costs than preparers without finance leases?

Please provide any evidence you have on the expected magnitude of the costs.

Costs for users

One-off costs

~~108~~114 Users may incur one-off costs to understand the new requirements, modify their processes and analyses and educate their staff. Costs to re-establish comparable information about trends may be more complex as preparers make use of the various transition options, exemptions and practical expedients in IFRS 16.

Ongoing costs

~~109~~115 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.

~~110~~116 EFRAG has considered whether IFRS 16 is expected to reduce the need for users to make adjustments to reported figures to estimate leases liabilities arising from operating leases, and therefore reduce their costs. In outreach with users, EFRAG has generally been advised that the information provided by IFRS 16 will provide a better starting point for their analyses and assessment. However, EFRAG understands that some users may continue to make adjustments. They may, for instance, want to include in their analyses those leases that are not recognised under the scope and recognition exclusions contained in the standard. Adjustments may also be needed to make information comparable for entities with different lease residual maturities.

Question for constituents

Are you aware of any costs for users in additional to those identified above? Please quantify if possible.

Benefits for users and preparers

~~111~~117 EFRAG has considered the benefits for users and preparers resulting from IFRS 16. The evaluation of benefits is by nature mainly qualitative because it is very difficult to quantify the benefits in monetary terms.

Benefits for users

~~112~~118 IFRS 16 provides a more accurate measure of the lease liabilities when compared to the estimates developed by investors and analysts to overcome the lack of information provided by applying IAS 17. This will allow users to better assess the financial position and financial performance of a lessee. IFRS 16 will also improve comparability, in particular in profit or loss, between entities that lease assets and entities that borrow to buy assets.

~~113~~119 EFRAG expects that IFRS 16 will provide users with an enhanced basis for their analyses that is likely to reduce the need, for many of them, to make adjustments to reported figures to estimate leases liabilities, or at least provide a better starting point for their analysis. EFRAG understands that some users will continue to make adjustments to enable existing data series to continue.

~~114~~120 IFRS 16 includes enhanced objective-based disclosure requirements that are likely to provide more relevant information to users because they are tailored to the lessee's specific portfolio of leases and help in forecasting future lease payments. EFRAG observes that this will create a more level playing field between sophisticated and unsophisticated investors by providing better information about leases to all interested parties and allow users to better assess the financial position and financial performance of a lessee.

~~115~~121 Overall, EFRAG's assessment is that users are likely to benefit from IFRS 16, because IFRS 16 results in more relevant and reliable information, increased comparability between entities and an enhanced basis for users' analysis. Benefits for users may however be reduced by the options, exemptions and practical expedients available in IFRS 16, both upon transition and on an ongoing basis.

Benefits for preparers

~~116~~122 EFRAG has assessed that IFRS 16 will improve the overall quality of financial reporting in comparison with IAS 17. Entities, when implementing IFRS 16, will typically also generate incremental management information that can be used for internal purposes. As noted, EFRAG anticipates that many entities will enhance their existing lease administration systems as part of their implementation efforts.

~~117~~123 For certain entities with large portfolio of leases~~,~~ , ~~By generating~~ the information required under IFRS 16, ~~lessees may~~ may result in a greater focus by management and by users on the effects of leasing activities~~ have improved information for internal decision making~~. This in turn may enable preparers to identify improvements in how they finance their assets and manage cash flows and capital allocation by enabling better credit and investment decision-making. Consequently, preparers may be able ~~are likely~~ to gain ~~better~~ insights into how they manage their financial leverage. ~~EFRAG expects that entities that need to make the most enhancements to their systems are more likely to benefit from improved information for decision-making. That is, entities bearing the greater costs are likely to reap the greater benefits.~~

~~118~~124 The requirements in IFRS 16 are expected to create a more level playing field between entities that lease and entities that purchase their assets by providing transparent information about leases. In particular, the requirement to separate lease components from non-lease components in a contract and apply respective stand-alone prices will enhance transparency and bring better pricing of different components.

~~119~~125 In addition, the elimination of the need to classify leases between operating and finance leases will reduce the existing judgement needed by preparers to separate leases into finance and operating, with a consequent reduction in cost. Preparers will not need to differentiate between different types of leases and maintain two systems in order to account for operating and finance leases separately, reducing costs in this respect.

~~120~~126 Overall, EFRAG's assessment is that preparers are likely to benefit from IFRS 16, which result in more relevant and reliable information, improved comparability and transparency about the effects of leases and therefore more level playing field. Preparers may also benefit from better economic decision-making resulting from improved financial reporting ~~on how they finance their assets and manage cash flows~~ and better insight into how their financial leverage (in particular for lessees in which the leasing activity is decentralised).

Questions for constituents

If a lessee has to develop new systems to support the accounting for leases, to what extent do you expect internal benefits from the information provided by the new information? Please quantify to the extent possible.

Do you agree with the benefits for users and preparers identified above? Are there any additional benefits for users and preparers? Please provide evidence where available.