

JOINT OUTREACH EVENT

WHAT IS NEW IN ACCOUNTING FOR LEASES: A CHANGE WORTH \$2.2 TRILLION!



BRUSSELS

5 JULY 2016

This summary report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by either the EFRAG Board or the EFRAG Technical Expert Group. It has been reviewed by the speakers who attended the joint outreach event.

Introduction

In January 2016, the IASB published IFRS 16 *Leases* which supersedes IAS 17 *Leases* 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*).

Prior to the issuance of IFRS 16, leases were classified as either finance leases, which transfer substantially all the risks and rewards incidental to ownership of an asset from lessor to lessee, or operating leases, all leases other than finance leases. Operating leases were not shown on the face of the balance sheet whereas finance leases were. Operating lease commitments were disclosed in the notes. There was some criticism from users of financial statements that IAS 17's accounting model for leases failed to meet their needs. In particular: the information reported by lessees about operating leases lacked transparency; the existence of two different lessee accounting models for leases meant that transactions that were economically similar could be accounted for very differently; and the information about a lessor's exposure to credit risk was not considered to be adequate.

The IASB addressed the issue by developing a new standard that 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 on the face of the balance sheet assets and liabilities for the rights and obligations created by leases. IFRS 16 also includes detailed presentation and disclosure requirements to give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of entities.

Objective of the Feedback Report

This feedback report has been prepared for the convenience of European constituents to summarise the joint outreach event held by EFRAG, in cooperation with EFFAS and BVFA/ABAF, on 5 July 2016.

The outreach event followed the publication of IFRS 16. The purpose of the outreach event was to:

- educate and inform about the main changes introduced by IFRS 16 compared to IAS 17 and the differences between IFRS 16 and the US GAAP equivalent standard; and
- obtain input, especially from users, for the development of EFRAG's endorsement advice on IFRS 16 to the European Commission.

The views expressed in this summary report reflect the individual views expressed by participants at the event.

Speakers at the event

Andrew Watchman, *EFRAG TEG Chairman*, opened and closed the event. **Fred Nieto**, *Head of Investor Engagement* at the IASB, gave an introduction to the main features of IFRS 16 relevant for users and the main differences with IAS 17 and the US GAAP equivalent. **Filippo Poli**, *EFRAG Research Director*, set the scene for the panel discussion by introducing the main questions on which EFRAG was seeking input for its endorsement advice. **Hans Buysse**, *Member of EFFAS Management Committee and EFRAG Board Member* and **Patricia McBride**, *EFRAG Technical Director*, facilitated the Panel discussion. The User Panel comprised **Matthias Maenhaut**, *Equity Markets Analyst* at ING; **Stuart Jennings**, *Regional Credit Officer* for EMEA and APAC at Fitch Ratings; **Ben Peters**, *Co-fund Manager* at Evenlode Income and *Chief Executive* of Wise Investment. The detailed programme is included in Appendix I. A summary of their profiles can be found in Appendix II.



Summary of observations

Panel members and participants expressed the following views:

- a) Advantages and disadvantages of IFRS 16 from the perspective of users of financial statements – the panellists agreed that the biggest advantages of the standard are related to the increased transparency and comparability of information for users, the comprehensive disclosure requirements, a more level playing field for all investors and better information about an entity's financial leverage. The biggest disadvantage identified by the panellists was the lack of convergence with the US GAAP.
- b) Population of contracts captured by the scope of IFRS 16 – the panellists noted that there might be an increasing trend away from lease contracts towards service-type contracts. They also expressed the view that some structuring opportunities may remain under IFRS 16.
- c) Presentation requirements in IFRS 16 – the common view expressed by the panellists was that the lease liability is not the same as a bank borrowing but that it still increases an entity's leverage.

- d) Effect on non-GAAP measures – the panellists anticipate that IFRS 16 will change the calculation of non-GAAP measures; however, it is hard to estimate this impact as there is no uniformity in the calculation of these measures.
- e) Overall impact from the new leases standard – the panellists considered that the change in accounting is not likely to cause a significant reduction in the use of leases as they will still provide advantages such as operational flexibility. They also did not expect a significant effect on loan covenants and access to financing for entities.

On balance, IFRS 16 was seen by users of financial statements as an improvement over the current IAS 17. However, some users will continue making adjustments to the financial information available for leases but they will have a better starting point for their analysis. IFRS 16 increases transparency and comparability of financial information, improves disclosure requirements and is not expected to have a negative impact on the access to financing for entities. Certain concerns were expressed about the lack of convergence with the US GAAP requirements.

Opening comments and Introduction to the Panel Discussion on IFRS 16 Leases

Andrew Watchman opened the joint outreach event and welcomed the speakers and the participants.

Andrew Watchman introduced the topic by highlighting the important changes that IFRS 16 would impose for both preparers and users of financial statements. He noted the IASB's estimate of the discounted value of off-balance sheet lease commitments of listed companies worldwide is \$2.2 trillion, of \$700 billion relates to the European market.

He explained that EFRAG needs to express a view, as part of its endorsement advice to the European Commission, on whether endorsing IFRS 16 will be conducive to the European public good. That would encompass macro-economic issues of competitiveness, financial stability and economic development.

He acknowledged the fact that the costs of implementation and compliance with IFRS 16 would be significant; however, the IASB believes that the benefits of obtaining better information in terms of transparency, comparability and an enhanced level-playing field for all market participants will outweigh the costs associated with the application of IFRS 16. He indicated that the outreach is trying to test some of these claims about benefits for analysts and investors.

Presentation on the main changes introduced by IFRS 16 Leases

Fred Nieto from the IASB presented the main changes introduced by IFRS 16.

Fred Nieto, Head of Investor Engagement at the IASB, provided a high-level overview of IFRS 16 and the main changes brought by IFRS 16 to accounting for leases for both lessees and lessors. His [presentation](#) concentrated mainly on how operating leases would be affected by the new standard; how IFRS 16 compares to IAS 17; and the potential effect of divergence with the requirements in US GAAP. He pointed out that the impact of the leases standard would be broad



and, at European level, would impact around 47% of all reporting entities.

Fred Nieto started his presentation by explaining why IFRS 16 was necessary. Under the preceding standard, information was missing from the balance sheet as to the level of indebtedness. This point was reinforced by referring to a number of retail chains in the US and Europe that filed for bankruptcy due to their inability to meet their debts (including their significant off-balance sheet lease commitments). The picture of indebtedness was highly distorted with entities that had high numbers of operating leases effectively understating their reported liabilities. There was a lack of comparability between these entities and entities that borrowed to buy assets. The overall effect was the lack of a level-information playing field for investors.

Fred Nieto explained that IFRS 16 broadly retains the definition of a lease used in its predecessor IAS 17. Consequently, he expected preparers to arrive at the same conclusion on whether a contract is or contains a lease in most situations. The scope exemptions for short-term leases and leases of low-value assets were provided for practical reasons and their impact was not expected to be significant.

Fred Nieto highlighted that the main change introduced by IFRS 16 is to require a lessee to recognise assets and liabilities arising from all leases on the balance sheet.

The income statement will also provide more detail about rental expense as it will be split into two components: depreciation and interest expense reflecting the recognition of a lease right-of-use asset and a lease liability. The pro-forma impact of IFRS 16 on the amounts reported in sub-totals such as EBIT (Earnings Before Interest, Tax) and EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation), would be to increase those figures, however, this increase would not necessarily trickle down to produce a similar effect on the pro-forma net profit before tax, since it would depend on the significance of leasing to the entity, the length of its leases and the discount rate applied.

As far as the comparison between IFRS 16 and the US GAAP equivalent is concerned, Fred Nieto noted that convergence is achieved for recognition and initial measurement of the right-of-use asset and lease liability in the balance sheet. The main area of divergence is with the presentation in US GAAP of former operating leases whereby a single lease expense is recognised in the profit and loss account and these leases are presented separately in the balance sheet. He commented that the disclosures required by US GAAP should compensate for the lack of convergence by providing investors with sufficient information to derive adjusted measures that are more comparable to amounts presented under IFRS 16. The other way round it would be easy to derive the US GAAP numbers from IFRS 16.

In summary, Fred Nieto outlined that the intended benefits from IFRS 16 are improved comparability by recognising and measuring all lease assets and liabilities in the same way, thereby reflecting management's operating decisions in the financial statements, along with enhanced disclosures focusing on the most relevant information for that entity.

Topics for the Panel Discussion

Filippo Poli set the scene for the Panel discussion.

The Panel discussion was preceded by an introduction by Filippo Poli who outlined the main areas where EFRAG is seeking user input on IFRS 16 to contribute to the development of EFRAG's endorsement advice. He set out three main directions of discussion:

- a) How the numbers produced by IFRS 16 would be used by users of financial statements;
- b) How well different aspects of IFRS 16 capture the right "picture"; and
- c) How different market participants might alter their economic decisions: whether entities would reduce their use of leases and whether there would be any effect on access to financing.

Detailed Panel Discussion

Hans Buysse and Patricia McBride opened the Panel discussion and welcomed both the panellists and the other participants at the event. They provided a short introduction to each of the questions.

Big change: all leases on the balance sheet. How will you use the numbers produced by IFRS 16?

The discussion was opened by a panellist who stated that IFRS 16 will bring a major positive change in accounting for leases. From the perspective of an equity analyst, it will improve the comparison between entities that finance their assets in different ways. Thus ratios across entities will become more comparable. This view was supported by another panellist who also observed that the financial leverage of an entity would be more transparent in comparison to IAS 17. However, he considered that some users would continue to make some adjustments to financial data.

Another panellist added that the additional disclosures required by IFRS 16 are an advantage however, he did not mind the "risk and reward" model of IAS 17 and expressed the view that this model highlighted entities' different business models. He also underlined

IFRS 16 brings a positive change by increasing transparency and comparability of financial data.

the importance of the cash flows and cash flow statement as basis for users' assessments.

The panellists generally agreed that the requirements in IFRS 16 bring a positive change to the reporting of leasing activities by improving transparency and comparability of financial data. They acknowledged that recognising assets and liabilities for all leases will be a significant change, however, the magnitude of this change would vary across economic sectors. The degree of support for the change expressed by the panellists also varied.



Lack of convergence was the main concern expressed by panellists.

The biggest advantages as seen by the panellists were: increased transparency and comparability of financial information, providing a level-playing field for all users of financial statements, enhanced disclosure requirements and better information about entity's financial leverage. The panellists acknowledged that these advantages would come with a cost for preparers in terms of implementation and compliance.

However, some panellists expressed the view that, irrespective of the introduction of IFRS 16, they will continue to make some adjustments in their analysis with respect to leases. In their view, leases should be analysed from the perspective of the entity's business model and their significance. The main disadvantage pointed out by some panellists was the lack of convergence with the US GAAP equivalent whereas IAS 17 and the current US GAAP equivalent are very similar.

A participant (preparer) raised concerns that the concept of a right-of-use asset was not easy to explain in practical terms. Another participant preferred the accounting treatment under the US GAAP equivalent as he considered the presentation of a constant single lease expense for former operating leases to be more appropriate. Additionally, he pointed out that the transition requirements in

IFRS 16 are likely to lead to a loss of comparable figures for trend analysis.

Some participants noted that also under IFRS 16 there could be structuring opportunities to avoid the recognition of liabilities. There was also a lack of clarity among some of the participants as to why capacity contracts (i.e. where the asset is not physically distinct) are excluded from the scope of the standard when the customer does not take substantially all of the capacity of the asset.

A panellist commented that it was difficult to assess whether IFRS 16 would create a trend towards shorter lease terms. He also noted that any such trend would be difficult to distinguish from changes in business models affected by technological disruptions and shifting consumer preferences.

Is the picture substantially right? Have the right contracts been identified?

In general, the panellists agreed that the scope of IFRS 16 was substantially right and they were not expecting any significant changes in the contracts identified as leases. A panellist, in responding to a question on whether the threshold of \$ 5000 for the low value asset exemption should be increased in view of the average equipment lease being \$ 25.000, expressed the view that the exemptions for leases of 12 months and of low-value items such as personal computers and office furniture seem practicable and workable.

There could be a trend towards service-type contracts.

Another panellist considered that there could be a trend towards service-type contracts or even a shift from holding an asset to owning it.

Members of the panel were asked whether it was useful for users of financial statements that assets of entities in the services sector, that are frequently leased, are recorded on their balance sheets. In response a panellist commented that for his approach to financial statement analysis and valuation the information presented in the balance sheet is not as important as the information presented in the statement of cash flows. As long as relevant disclosures about cash flow movements are provided, users are able to better understand entity's cash flow risks and liquidity problems.

How should leases be presented?

A lease liability was not perceived as a bank borrowing by the panellists.

Some panellists considered that a lease liability is not the same as a bank borrowing but that they still increase an entity's leverage.

With respect to the presentation of interest expense on the lease liability, a panellist expressed his view that it should not be presented separately but rather as a single line expense similar to the US GAAP presentation. A thought-provoking question was raised by one of the moderators about the accounting treatment of interest

expense for finance leases under the current IAS 17. In response, this panellist said that his choice of accounting treatment would be different depending on the lease term of the contract. For contracts covering the whole life of the asset he would account separately for the interest expense as finance costs, however, for contracts covering only part of the life of the asset he saw no need to report the interest expense separately.



Divergence in presentation requirements under IFRS 16 and US GAAP hinders comparison and but does not impact the level-playing field.

This panellist commented also that the divergence in presentation requirements between IFRS 16 and the US GAAP equivalent makes the comparison of financial information between entities more complex but does not impact the level-information playing field.

Does it matter that non-GAAP measures will change?

On balance, panellists agreed that the calculation of non-GAAP measures will change due to the implementation of IFRS 16. However, they noted that entities are already not consistent in the presentation of their non-GAAP measures. They considered that users will continue to make some adjustments.

One panellist pointed out that a potential problem would be to adjust either future or historical lease information so that a consistent analysis can be undertaken.

How will the world react?

Leases will still be around providing operational flexibility to entities.

A panellist commented that the operational flexibility that lease contracts give to entities is a very strong incentive for entities to continue using these type of contracts unless their business model changes. Similarly, another panellist also did not expect changes as entities look at the economic reality of transactions and not the accounting when making decisions.

This panellist considered that debt covenants may change; however, the lending process is interactive and so the potential effect of

IFRS 16 may be a negotiation point. He did not anticipate a significant impact on access to finance even for smaller entities. In his view, lenders and other providers of finance are governed in their decision by the real economic risk and business operations of entities rather than changes caused by accounting standards. He observed that issues such as VAT, direct tax and public procurement requirements play a role. For SMEs, which are mainly governed by local GAAP, he expected that IFRS 16 will not have a significant impact.

Views on potential costs of implementation

The panellists agreed that the cost of IFRS 16 for users will not be significant when compared to the costs for preparers as they have well-developed systems in place to facilitate their analysis and, as a result, will only need to change the type of adjustments they do to the reported financial figures. With respect to preparers, a common opinion was shared that preparers will- like for other new or revised standards - have to incur the majority of the costs associated with the implementation of IFRS 16.



Overall views

Although the panellists' overall assessment of IFRS 16 was positive, they saw pros and cons: it comes down to having the benefit of more transparency from having all leases on the balance sheet and disclosures that facilitate their analysis versus the disadvantage of having a more technical standard. On balance, they see IFRS 16 as an improvement over its predecessor IAS 17 as IFRS 16 increases transparency, comparability and enhances disclosure. As the main drawback, they pointed to the lack of convergence with US GAAP.

Preparers will have more judgements to make such as assessing changes in the terms and conditions of a lease.

One participant (user) indicated that he is in favour of the US model but acknowledged that the requirements of IFRS 16 meant that it would be possible to derive the equivalent US GAAP amounts. Another participant considered that the implementation of IFRS 16 will take time and resources particularly for preparers that currently have a high volume of operating leases but no central database that capture the necessary information.

Concluding remarks

Andrew Watchman thanked the panellists and participants in this event for the valuable feedback, which will be considered by EFRAG in the development of the endorsement advice on IFRS 16 for the European Commission. He observed that the feedback on IFRS 16 was modestly positive as users will continue making adjustments to the financial information available for leases but they will have a better starting point for their analysis. It was noted that transparency and comparability will increase and, as a result, less sophisticated users may benefit most from the standard. There was no anticipation that there would be a negative impact on access to financing. The majority of the costs of implementation of IFRS 16 would fall on preparers. Concerns were expressed about the lack of convergence with the US GAAP requirements.

APPENDIX I PROGRAMME

WHAT IS NEW IN ACCOUNTING FOR LEASES: A CHANGE WORTH \$2.2 TRILLION!

JOINT OUTREACH EVENT - EFRAG OFFICES TUESDAY 5 JULY 2016 - 10.30 - 13.30

PROGRAMME

10.30-11.15 Registration – welcome coffee

11.15-11.25 Opening and introduction by Andrew Watchman, EFRAG TEG Chairman

11.25-11.55 Presentation of the main changes in IFRS 16 leases compared to IAS 17 and US GAAP, by Fred Nieto, Head of Investor Engagement, IASB

11.55-12.10 Issues in IFRS 16 on which EFRAG is seeking user input, Filippo Poli, EFRAG Research Director

12.10-13.25 Roundtable discussion featuring users and interactive discussion with the audience, moderated by Hans Buysse, Member of EFFAS Management Committee and EFRAG Board Member, and Patricia McBride, EFRAG Technical Director

USERS

Matthias Maenhaut, Equity Analyst at ING

Stuart Jennings, Regional Credit Officer at Fitch Ratings

Ben Peters, Fund Manager and CEO at Evenlode Investment

- *Big change: all leases on the balance sheet. How do you react?*
- *Is the picture substantially right? Have the right contracts been identified?*
- *How should leases be presented?*
- *Does it matter that non-GAAP measures will change?*
- *So, how will the world react?*

13.25-13.30 Summary and closing by Andrew Watchman, EFRAG TEG Chairman

13.30 Sandwich lunch

APPENDIX II: SPEAKERS' BIOGRAPHIES



Andrew Watchman

Andrew Watchman joined EFRAG as CEO and TEG Chairman in April 2016.

Prior to joining EFRAG Andrew was the Global Head of IFRS for Grant Thornton, leading a team supporting the application of IFRS across the international network and chairing the firm's global IFRS expert group. Responsibilities included consulting on technical issues, developing publications, delivering training and responding to IASB proposals. Between July 2013 and joining EFRAG Andrew also served as a member of the IFRS Interpretations Committee.

Prior to joining Grant Thornton Andrew served as Accountancy Adviser to the UK's Department of Trade and Industry (DTI), providing expert advice on public policy in financial reporting and the transition to IFRSs in the UK. Prior to that Andrew spent fourteen years in the audit practice of an international accounting firm, up to partner level.



Fred Nieto

Fred joined the IASB in June 2013, and as of June 2016 is the Head of Investor Engagement. This role involves leading investor engagement activities, both maximizing the possibilities afforded by investor participation in the development of IFRS standards and acting as an advocate for investors' views internally. His previous role at the IASB was as the Investor Education Manager.

Prior to joining the IASB, Fred worked as an equity research analyst in London on the sell-side and on the buy-side. His experience includes having covered the European Insurance sector at UBS Investment Bank and Execution Limited, and having covered the global financials sector at a long/short equity hedge fund. Fred earned an MSc in International Accounting & Finance from the London School of Economics and is a holder of the CFA designation.



Filippo Poli

Filippo Poli joined EFRAG in April 2009 and was appointed as EFRAG Research Director in 2014.

Filippo has worked for PwC for more than 15 years as an auditor and member of different IFRS technical committees. His international experience includes periods in Paris and Warsaw.

Before that, he graduated from in Accounting & Finance at Bocconi University in Milan.



Hans Buysse

Hans Buysse is the EFRAG Board member on the user seat since November 2014. Hans is Vice-Chairman of the Belgian Association of Financial Analysts. He is EFFAS Executive Management Committee member and Treasurer and XBRL Europe Executive Committee member.

Hans Buysse is a partner of Clairfield Benelux nv, based in Brussels. Clairfield International is a worldwide corporate finance firm that provides advisory services, mainly in cross-border mergers and acquisitions. Hans has more than 20 years banking and corporate finance experience. This includes buy side and sell side assignments, as well as MBO and IBO, within the energy & utilities sector, telecom, real estate and infrastructure.



Patricia McBride

Patricia McBride joined EFRAG in April 2014 as Technical Director.

Although she is a UK citizen, she has spent most of her career working in Asia-Oceania. She is well known in the international IFRS arena for her technical roles supporting the standard setters in Australia, New Zealand and Hong Kong. Part of her career was spent in academia and in her earlier days she was Chief Accountant of a subsidiary of a large German corporate for eight years. She has written for textbooks, academic journals and newspapers and has extensive experience explaining technical accounting issues to non-accountants.



Matthias Maenhaut

Matthias Maenhaut joined ING Equity Markets in 2012 and is now covering the beverages and food retail sector. Prior to this, he worked as a Credit Risk Analyst at ING for two years. He also worked as a Credit Analyst at Allianz. Matthias completed a postgraduate in Corporate Finance at the University of Leuven, obtained a Masters in Finance at the University of Gent in 2006 and passed level II of the CFA program.



Stuart Jennings

Stuart Jennings is Regional Credit Officer for EMEA and APAC at Fitch Ratings, responsible for monitoring credit across sectors in these regions. Before that he was Group Credit Officer for Global Structured Finance and Covered Bonds responsible for the quality of rating analysis within the agency's portfolio of ratings in this area. Prior to this Stuart headed Fitch's European residential mortgage-backed securities group.

Prior to joining Fitch in 1999, Stuart was in the asset securitization group at Credit Suisse First Boston.

Stuart earned his BA degree in accounting and French at the University of Kent at Canterbury. He is also a qualified chartered accountant.



Ben Peters

Ben is co-fund manager of Evenlode Income, a UK equity income fund, and Chief Executive of its parent company, Wise Investment. He joined Wise in 2008 and launched Evenlode along with colleague Hugh Yarrow in 2009. Ben is actively engaged with the financial community through bodies such as the Corporate Reporting Users Forum, CFA Society and the Investment Association. Aside from financial analysis, he takes a wider interest in matters of corporate governance from an investor's perspective. Previously a physicist, Ben holds a doctorate from the University of Oxford from his work in the field of nanoelectronics.