

EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

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IFRS 16 Leases

Summary of work to date and next steps

Objective

- 1 The objectives of this session are:
 - (a) To provide an update on the feedback received from constituents in response to EFRAG's Preliminary Consultation Document and to its additional questionnaire addressed to users and how it may inform the Draft Endorsement Advice
 - (b) To discuss the additional work conducted by the EFRAG Secretariat to assess whether the effects of IFRS 16 will be proportionate to SMEs; and
 - (c) To discuss the next steps in the endorsement advice process.

Feedback from EFRAG's consultations

- 2 On 12 October 2016, EFRAG published a Preliminary Consultation Document ('the PCD') regarding the endorsement of IFRS 16 calling for comments by 8 December 2016. EFRAG also published on 7 November 2016 a questionnaire seeking the views of users and user organisations on a number of issues in relation to its assessment on costs and benefits and whether IFRS 16 is an improvement over IAS 17.
- 3 EFRAG's preliminary assessment was that IFRS 16 meets the technical criteria for EU endorsement; is not contrary to the true and fair view principle; is a significant improvement to the reporting of leases compared to IAS 17; provides for more transparent and meaningful information on leasing arrangements to be reported and would not put European entities at a competitive disadvantage notwithstanding the lack of convergence with the equivalent US GAAP Standard.
- 4 EFRAG also prepared a preliminary assessment of the cost and benefits expected to arise from the application of IFRS 16 although it was not in position to assess whether benefits would outweigh costs.

Summary of the feedback received

- 5 EFRAG received 32 responses to the PCD and 25 responses to the user questionnaire. A detailed analysis of the feedback received is contained, for background only, in agenda paper 09-02.

- 6 In summary, the feedback received is consistent with previous views expressed by the different stakeholders during the development of the standard:
- (a) Broad support for the new standard from (an overwhelming majority of) the user community, standard setters, accounting organisations and a regulator and agreement with EFRAG's initial assessment that IFRS 16 is an improvement over IAS 17
 - (b) Mixed views expressed by preparers. Some consider the new standard as an improvement while others question the benefits of recognising all leases on the balance sheet in their industries and consider that IAS 17 provides a better alignment of cash flows and results. These respondents pointed to the extent of costs for preparers, the extent of judgement required to apply IFRS 16 and some identified limitations.
 - (c) Concerns expressed by leasing associations (mainly representing lessors of equipment and vehicles) about the potential adverse effects on IFRS 16 on their business model and for the leasing industry at large.
- 7 Most respondents to the consultations stated that they were not in a position to comment how IFRS 16 will affect their cost of capital and the effects on financial stability in general. However, some respondents from the financial sector considered that the effects of IFRS 16 on the cost of capital and financial stability in general should be essentially assessed though the impacts on banks' prudential ratios and raised concerns about the lack of clarity on the treatment of right-of-use assets for the determination of banks' solvency leverage and liquidity ratios.
- 8 In addition to the responses to its public consultations, EFRAG also received on 12 December 2016, a letter from the European Central Bank (ECB) on the effects of IFRS 16 on financial stability (Agenda paper 09-04).
- 9 In its letter, the ECB has assessed that, it has 'not identified conclusive evidence to indicate that IFRS 16 would pose a significant risk to financial stability in Europe'. The ECB's conclusions have been reached on the basis of a qualitative assessment of IFRS 16 against the ten high level principles of assessing accounting standards from a financial stability perspective as set out in a report of the European System of Central Banks. The ECB also commented that it would be important to monitor the quantitative effects of IFRS 16 after the new accounting standard comes into effect in January 2019.
- 10 All letters received in response to the PCD are available on EFRAG's Public Website. In addition to the ECB letter, letters from other official observers to the EFRAG Board are also uploaded as Agenda papers (namely ESMA's response to the consultation contained in Agenda paper 09-05).

EFRAG TEG's discussion on the feedback received and how it may inform the Draft Endorsement Advice

- 11 EFRAG TEG discussed the feedback received from constituents at its December meeting. EFRAG TEG considered in particular:
- (a) the support received from a majority of respondents, including the user community;
 - (b) the fact that most of the limitations with regard to relevance, reliability and/or comparability identified by some respondents were already acknowledged in EFRAG's Preliminary Assessment (including the extent of judgement required to apply IFRS 16 and some identified limitations linked to options and practical expedients) but had been assessed to constitute an acceptable trade-off

between the completeness and faithful representation of information on the one hand and the costs and complexity of applying IFRS 16 on the other hand.

- (c) These limitations had not been assessed to prevent IFRS 16 from overall meeting the said qualitative characteristics or being contrary to the true and fair view principle and EFRAG TEG had not identified reasons to revise that assessment based on the feedback received.
- 12 Based on the above, EFRAG TEG recommended that the forthcoming Draft Endorsement Advice should reiterate the preliminary assessment that IFRS 16 meets the technical criteria for EU endorsement; is not contrary to the true and fair view principle; is a significant improvement to the reporting of leases compared to IAS 17 and provides for more transparent and meaningful information on leasing arrangements.
- 13 However, EFRAG TEG also recommended to include a number of improvements to acknowledge and address some of the issues raised by constituents:
- (a) Report the concerns expressed by various respondents about the timeliness of the endorsement process and the problem that may arise if entities were not in a position to adopt it in 2018 together with IFRS 15. This issue was already raised at the EFRAG Board meeting in October and shared with representatives of the European Commission at the time. It is proposed to report it in the cover letter to the Endorsement Advice;
 - (b) Report the concerns expressed by some respondents as the need to clarify the interaction of the new standard with regulatory capital requirements of financial institutions, although noting that EFRAG is not in a position to interpret or provide clarification of such interactions;
 - (c) Further explain why the concepts of right-of-use and of control, as defined in IFRS 16, are appropriate in the case of leases;
 - (d) Expand the discussion on the complexity and level of judgement created by some requirements in IFRS 16, such as the existence of substitution rights and the assessment of the lease term in the presence of renewal and termination options; and
 - (e) Revise the assessment of costs for lessors to clarify that, although lessor accounting is substantially unchanged, lessors could incur additional costs to develop systems to provide information to lessees (e.g. interest rate, stand-alone prices of components).
- 14 Regarding the assessment of costs for preparers, EFRAG TEG observed that, although respondents generally considered that one-off and ongoing costs of applying IFRS 16 could be significant for them, very few respondents were in a position to provide some form of quantitative assessment. In that regard, EFRAG TEG expected more input to be provided by the extensive outreach and interviews conducted by the economic consultant commissioned by EFRAG before forming a view as to whether the benefits of IFRS 16 outweigh its costs.

Additional work to assess whether the effects of IFRS 16 will be proportionate to SMEs

- 15 In its request for advice on the endorsement of IFRS 16, the European Commission required that EFRAG should analyse how IFRS 16 could affect small and medium-sized enterprises (SMEs) that use IFRS under Member States options or to meet reporting requirements of non-regulated markets.

- 16 During the comment period to EFRAG's PCD, the EFRAG Secretariat has conducted additional work and sought information from Member States and other sources in Europe to identify:
 - (a) The extent to which unlisted SMEs are likely to apply IFRS 16; and
 - (b) Whether IFRS 16 is proportionate to SMEs.
- 17 The EFRAG Secretariat reached out to all Member States (and the European Economic Area) through National Standard Setters and the Accounting Regulatory Committee to seek information on the number of entities, not listed on a regulated market, reporting under IFRS under Member State's options. Information has been obtained for 25 of the 28 EU countries and for 1 of the 3 EEA countries.
- 18 The EFRAG Secretariat has also reached out to a number European organisations of listed and non-listed SMEs and considered a number of reports to identify the extent to which SMEs used leasing and the types of leased assets.
- 19 In summary, the feedback received has confirmed that:
 - (a) The number of SMEs likely to apply IFRS 16 is expected to be very limited throughout the European Union as the feedback received suggests that less than 1% of SMEs apply IFRS;
 - (b) However, some metrics indicate that SMEs are proportionately more reliant on leasing than large businesses. It is also evident that SMEs lease a wide range of asset types including premises, vehicles, plant and machinery, ITC, and office equipment;
 - (c) SMEs generally enter into leases that are straightforward and do not include complex terms, although exceptions may exist in specific industries.
- 20 Although only a very small percentage of SMEs would apply IFRS 16 (if endorsed), the absolute number of SMEs that would apply the new standard is potentially large. EFRAG Secretariat therefore assessed whether the effects of IFRS 16 will be proportionate to those SMEs that will apply IFRS. To assess whether IFRS 16 will be proportionate to SMEs, the EFRAG Secretariat considered:
 - (a) Whether the administrative burden will be proportionally greater for SMEs; considering in particular the types of leased assets;
 - (b) Whether the accounting impact will be proportionally greater for SMEs based on a quantitative assessment prepared on a sample of SMEs);
 - (c) Whether the economic/business impact will be proportionally greater for SMEs – for instance, whether the cost of capital for SMEs will increase proportionally more than for non-SMEs.
- 21 The EFRAG Secretariat's tentative conclusion is that there is no evidence that the administrative burden arising from IFRS 16 or the accounting impacts will be disproportionate to SMEs.
- 22 Regarding the economic and business impacts, the conclusion will be informed by the study commissioned with Europe Economics. However, the first indications (see Progress Report presented at the December EFRAG Board meeting) are that the implementation of IFRS 16 has a low likelihood of triggering a material change in leasing availability and lease pricing for SMEs.
- 23 The detailed assessment is contained in Agenda paper 09-03; which is provided for background only.

Work Plan for effective completion of the endorsement Advice

- 24 The complete draft report from Europe Economics is expected to be received by the end of next week (9 January 2017). This study is expected to provide significant input into EFRAG's analysis of the impact of IFRS 16 on European Public Good and in particular in the following areas:
- (a) The impact of IFRS 16 on the behaviour of preparers, investors and lenders and the impact of anticipated behavioural changes on the European economy;
 - (b) The impact of IFRS 16 on the leasing industry;
 - (c) The economic and business impact of IFRS 16 on SMEs;
 - (d) The benefits and costs of implementation of IFRS 16 (in addition to the feedback received from the 2016 consultations).
- 25 Based on that, the following work plan could be considered:
- (a) EFRAG TEG meeting 25-26 January: to discuss and agree to recommend, to the EFRAG Board, a complete Draft Endorsement Advice (including changes to address feedback received from the 2016 consultations and initial assessment on European Public Good);
 - (b) EFRAG Board meeting 7 February: to discuss and approve a Draft Endorsement and Invitation to Comment for a very short consultation period (2 weeks) focused on the assessment on European Public Good contained in Appendix 3; and
 - (c) EFRAG Board meeting 16 March: to discuss and approve a Final Endorsement Advice.

Questions for the EFRAG Board

- 26 Do EFRAG Board members have comments on the feedback received from respondents and the proposed changes to be included in the forthcoming Draft Endorsement Advice?
- 27 Do EFRAG Board members have comments on the additional work conducted to assess whether the effects of IFRS 16 will be proportionate to SMEs?
- 28 Do EFRAG Board members have comments on the proposed timeline for the endorsement process for endorsement?

Background papers

- 29 In addition to this summary, the following agenda papers are provided for background purposes only:
- (a) Agenda paper 09-02 - Analysis of feedback received from the consultations;
 - (b) Agenda paper 09-03 - *Assessing whether the effects of IFRS 16 will be proportionate to SMEs*;
 - (c) Agenda paper 09-04 - *Letter from the European Central Bank on financial stability*; and;
 - (d) Agenda paper 09-05 - *ESMA's comment letter in response to the Preliminary Consultation Document*.