EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

IFRS 16 *Leases*

Summary of Comment Letters received in response to EFRAG's consultations

Objective

1 The purpose of this paper is to present a summary of the comments made by constituents in response to:

(a) EFRAG's Preliminary Consultation Document (PCD) regarding the endorsement of IFRS 16 *Leases* issue; and

(b) EFRAG's additional questionnaire addressed to users

Overview of the consultation

2 At the time of writing, EFRAG received 32 responses to the PCD and 25 responses to the users' questionnaires. The table below provide a breakdown of respondents by types and countries. A full list of PCD respondents is included in Apppendix 1.

Profile of respondents to the PCD

By type		**By country**	
Users and organisations of users	3	Austria	1
Preparers and organisation of preparers	14	BENELUX	3
Leasing Association	5	Europe	6
Standard Setters	7	France	7
Professional organisations	2	Germany	6
Regulators	1	Italy	2
		Lithuania	1
		Spain	1
		Sweden	1
		UK	4
Total	**32**	**Total**	**32**

Profile of respondents to Users' Questionnaire

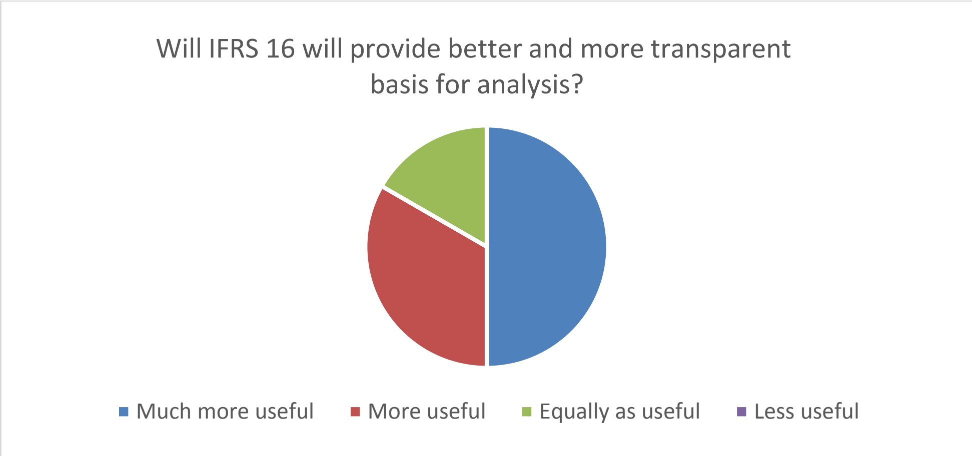
By type		By country	
Investor	2	BENELUX	3
Analyst (Buy-side)	8	Europe	3
Analyst (Sell-side)	3	France	4
Analyst	3	Germany	2
Analyst organisation	4	Italy	1
Credit Rating Agency	1	Portugal	1
Non-users	4	Spain	1
		UK	10
Total	**25**	**Total**	**25**

The main feedback provided is summarised below by category of respondent.

Feedback provided by users and user organisations

3 Users essentially provided input on the assessment of cost and benefits, how reported information will be used and whether adjustments will continue to be made.

4 Most respondents considered that IFRS 16 would provide better and more transparent information on lessees and a better starting point for their analyses, as shown in the graph below:



5 Users generally considered that recognition of lease obligations on the balance sheet, together with the enhanced disclosure requirements of IFRS 16, will improve comparability of financial information provided by companies, will make it easier to monitor companies and reduce risk. Respondents identified the following benefits:

(a) Four respondents noted that in some industries transparency will increase greatly and the ability to make investment decisions will improve with a decline in investment risk.

(b) Four respondents indicated IFRS 16 will increase both investor protection and market confidence, but it will be necessary to examine the results in practice.

(c) Two respondents noted that IFRS 16 will improve comparability across companies.

(d) Three respondents indicated that the implementation of IFRS 16 will also have an impact on how contracts will be negotiated in the future.

6 One respondent considered that capital markets will be more efficient with the introduction of IFRS 16 due to fewer estimates being needed. The respondent also noted that it would be unlikely to incur any additional costs as a result of adjustments currently being made for material leases.

7 Conversely, only three respondents noted that there will be no improvement for them in the quality of information because adjustments for operating leases were already made.

Usefulness of information provided by IFRS 16

8 Most respondents indicated that they are currently adjusting figures reported about leases in financial statements (18 out of 24 respondents) and most of them expect to continue making some level of adjustments after IFRS 16 is implemented (14 out of 18) although the other expects that adjustments will be reduced compared to today.

9 Adjustments are currently typically being made to the liability profile of an entity in order to reflect the lease liability. Some mentioned that they also make adjustments to the asset base. Some respondents indicated that adjustments are also being made to ratios such as return on capital employed, "profitability expressed as a return on (for leased assets) capital employed" and "leverage risk".

10 The main reasons for continuing to adjust the financial statements are linked to the following:

(a) IFRS 16 requires capitalisation based on contractual terms and adjustments will be necessary to reflect underlying economics and differing lease periods and differences in depreciation of related assets; and

(b) the impact of contingent rentals, which are currently excluded from the calculation.

11 One respondent indicated that adjustments would still be needed for certain sectors (retail, energy, trucking, hotels and restaurants) to capture the true leverage and risks in these sectors.

12 One credit rating agency noted that for its analytical adjustments, it was very important that a 'finance lease' is distinguished from an 'operating lease'. They recommended that right-of-use assets are sub-classified into those two categories. If this distinction is not possible, they would recommend as part of future improvements that IFRS 16 requires the disclosure of the discount rate or weighted average discount rate and lease term or weighted average lease term.

13 A majority of users have indicated that they do not expect to adjust for the recognition exemptions applicable to leases of low-value assets and short-term leases as shown in the table below:

Do you expect to adjust for	**Yes**	**No**	**No answer**
a) Low-value assets	4	16	5
b) Short-term leases	7	13	5

14 Eleven respondents indicated that their final decision might also depend on the amounts involved by the exceptions.

Users' view on costs expected to arise from the application of IFRS 16

15 Respondents were asked to grade one-off and ongoing costs on a scale from 1 (a lot less) to 5 (a lot more).

16 Users generally considered that they could incur incremental one-off cost to update their data, processes and systems and to get acclimatised to the new requirements (majority of respondents graded that cost between 2 and 3). However ongoing costs were deemed unlikely to increase significantly (majority of grades between 1 and 2). However no precise quantification was provided.

Feedback provided by preparers and their organisations

17 EFRAG received feedback from 14 preparers[1]. Preparers commentary focussed on

(a) The effective date of IFRS 16 and the timing of the endorsement in the EU;

(b) Whether IFRS 16 is an improvement over IAS 17;

(c) Whether it achieves an acceptable costs and benefit trade off;

(d) The effects on the behaviour of lenders and cost of capital;

(e) The effects of the new standard on regulatory capital requirements.

Effective date of IFRS 16 and timing of the endorsement process

18 Most preparers indicated that the decision on the transition method had not yet been made (full or limited retrospective approach). They generally considered that the decision will be based on cost and comparability.

19 Several respondents assessed that it was of the utmost importance that IFRS 16 is endorsed in a timely manner as:

(a) some preparers are considering early adoption as of January 2018, so as to apply IFRS 15 and IFRS 16 at the same date and they would not be in a position to do so if IFRS 16 is not endorsed by the end of 2017; and

(b) the cost of endorsement will be significantly increased if the endorsement is delayed.

20 This concern has also been echoed by another respondent in their comment letter based on the feedback they received from their constituents.

21 Considering the cost and complexity of IFRS 16, its interactions with IFRS 15 and the likely timeline for the endorsement process, one constituent suggested to 'bifurcate' the application dates of lessee and lessor accounting and allow preparers to early apply only the provisions on lessor accounting as of January 2018, and apply lessee accounting later in January 2019.

Is IFRS 16 an improvement over IAS 17?

22 Preparers expressed mixed views on whether IFRS 16 is an improvement over IAS 17.

---

[1] Feedback received from Leasing Associations representing lessors is presented separately hereafter.

23 Some preparers questioned the benefit of reporting all leases on the balance sheet in their industries and considered that IFRS 16 would not lead to proper accounting by failing to acknowledge the different nature of leasing. In particular:

(a) the right-of-use model did not depict the business model of the entities; and

(b) the benefit of the new accounting model was questionable or at best limited, while the cost to apply it was extremely high;

24 On the contrary, other preparers and preparer considered that IFRS 16 was an improvement over IAS 17 in that it will improve consistency, comparability and transparency.

25 One preparer organisation regretted that the IASB had not considered more thoroughly the effects of IFRS 16 on SMEs and considered that the case had not been made about its usefulness for SMEs.

Costs and benefits trade-off

26 Preparers generally considered that the one-off and ongoing costs of applying IFRS 16 will be significant, although most of them stated that they were still in the early stages of their project and could not provide any form of estimate. However:

(a) one preparer which started its transition project in January 2016, considered that the overall cost of the transition will be in the region of € 2 to € 2,5m (or 2000 days/people plus IT costs).

(b) another preparer considered the incremental one off and ongoing costs to be ‘within the single digit million’.

27 In general, the categories of costs identified in EFRAG’s PCD were considered relevant. However, some preparers emphasised that <u>ongoing costs</u> for preparers could be understated as costs would also arise from:

(a) increased audit and control (including internal control) and the ongoing maintenance of systems and licensing; and

(b) certain types of leases that are frequently revised (e.g. retail) and/or contain various extension options make some of their leases indefinite term leases.

28 One preparer considered additional costs may be incurred by lessors as lessees are expected to ask for more detailed information which may be costly to provide. (See also feedback provided by leasing organisations hereafter).

29 Two preparers indicated that there was currently no comprehensive system that could incorporate all the changes required by IFRS 16. Such a solution would have to be interfaced with their existing software modules which differs from country to country. Therefore, it was felt that part of the transition process and lease contract follow up will have to be manual (or through development of own tools).

30 To mitigate costs, most preparers indicated that they will consider using the recognition exceptions for leases of assets of low value and for short-term leases. Leases of office equipment, small IT and printers would typically fall into the low value exception. In that respect, one respondent however considered that the costs of providing the short-term lease information (disclosure about payments made) would offset the benefits of the exception.

31 Most preparers did not expect that the short-term exception will provide sufficient cost relief for preparers. They observed that, in their business, a lease rarely has a maximum possible term of 12 months or less (considering also renewal options).

32 Most preparers doubted that entities which already have finance leases would incur lower costs.

Effects on behaviour of lenders and cost of capital

33 Most preparers stated that they were not in a position to comment how IFRS 16 will affect their cost of capital. Those who commented expressed split views based on essentially anecdotal input.

(a) Some preparers assessed that it is unlikely that the cost of capital is affected by IFRS 16. One preparer, for instance, stated that the cost of capital and access to finance is linked to creditworthiness of entities which is not affected by IFRS 16 and the effects of leases are already generally adjusted by users, including lenders;

(b) Conversely, a few preparers considered that IFRS 16 could lead to a deterioration of capital and liquidity ratios and that there was a risk of higher cost of capital, aggravated access to capital markets and higher borrowing costs. Investors that had not previously made adjustments for leases may revise their investment decisions.

(c) One organisation considered that the impact of IFRS 16 on lenders will depend on the features in existing loan agreements and whether they include clauses such as automatic renegotiation or 'frozen GAAP'. In the absence of such clauses, some waivers or contract renegotiations could be expected in the case of breach of covenants.

Effects on regulatory capital requirements

34 Some financial institutions and preparer organisations representing them generally assessed that the effects of IFRS 16 on the cost of capital should be essentially assessed though the impacts on banks' prudential ratios.

35 These respondents stated that the major concerns for banks as lessees was the lack of clarity about the prudential impacts of the changes to the lease accounting. They considered that the interaction between IFRS 16 and financial stability in Europe should be analysed in terms of impacts of prudential ratios and in particular:

(a) How the right-of-use assets will be classified under regulatory requirements; i.e. as intangible or tangible assets depending on the underlying assets. This in their view would influence the risk-weighted assets and, with it, the capital ratios used for calculation of the regulatory capital.

(b) How international regulation would treat the new right-of-use assets notably regarding the calculation of leverage and the solvency ratios.

36 Two respondents considered that an impact assessment conducted by EFRAG or European agencies was needed to confirm the prudential effects of IFRS 16. before issuing an endorsement advice

37 One respondent indicated that in the absence of clarity about prudential treatment it was difficult for entities to decide on a transition method.

38 This concern has also been echoed by one Standard Setter based on the feedback received from constituents. This respondent commented that, as nothing has changed from a risk perspective, the accounting change introduced by IFRS 16 should not, by itself, impact the regulatory capital and leverage ratio requirements.

Feedback provided by leasing associations (representing lessors)

39 EFRAG has received feedback from (5) leasing associations representing lessors.

40 All but one respondent reported that they did not agree with EFRAG's tentative view that IFRS 16 meets the qualitative characteristics of relevance, reliability, comparability and understandability and is not contrary to the true and fair view principle. They generally saw IFRS 16 as an unnecessary revision to IAS 17 and that IAS 17 provides a clearer view on cash flows and results. One respondent considered that objective of IFRS 16 would have been better served with additional disclosures added to IAS 17.

41 One respondent considered that IFRS 16 will have a negative impact on the business model of institutions in Europe currently offering leases that include services by introducing an inappropriate distinction between leases and service contracts and an overly complex substantive right of substitution requirement. In their view, IFRS 16 would contradict customers' needs that are increasingly requiring an all-in service and are less attached to ownership. This could impair the functioning of the lease financing market.

42 Representatives of the car leasing industry also stated that bringing all leases on balance sheet does not provide useful information as services associated with rental of cars are inextricably linked and form part of the "mobility" package sold which is the main reason for entering into a vehicle lease.

43 One respondent stated that, because of its perceived negative effects on the leasing industry, IFRS 16 would contradict other EU initiatives such as Investment Plan for Europe, Circular Economy, the Sharing Economy, Promoting Green investment including green cars, promoting the European automotive manufacturing industry and would therefore not be conducive to European Public Good.

44 Some respondents stated that lessors would incur significant costs to develop systems to provide information to lessees (interest rate, stand-alone prices of components). Sharing of information about components of a contract and stand-alone selling prices could have an effect on business, as the lessee may want to acquire the services separately.

45 Furthermore, they considered that although the clear majority of SMEs in Europe are not expected to apply IFRS 16, there is a 'severe risk of contagion to areas outside its scope' i.e. in local accounting and tax rules. In that respect, one respondent observed that once new international rules are in place there is always an argument that national standards should change to achieve consistency. In their view IFRS 16 was not tailored for SMEs and its application would be too complex and costly.

46 To address these concerns respondents made the following suggestions:

(a) ask EFRAG to recommend in its endorsement advice that IFRS 16 should not apply to SMEs and that the standard does not spread indirectly to local GAAP;

(b) modify the requirements on substitution rights that are deemed too restrictive and would result in considering as non-substantive most of the very reasons why lessors are likely to replace assets, for example a change to the customer's planned use of the equipment;

(c) revise the exception on small assets to make it more useful: for instance apply a threshold of 5 000 USD to annual rental cost of 5 000 EUR and not to the value of underlying asset;

(d) consider reducing disclosure requirements; and

(e) allow more time for European lessees and lessors to apply IFRS 16 to allow them to put in place the systems and processes necessary to provide needed information to lessees. One respondent suggested to reschedule the application date to 2020.

Feedback provided by Standard Setters, accounting organisations and regulator

47 Responses have been received from seven Standard Setters, two accounting organisations and one regulator.

48 Most respondents specifically agreed with EFRAG's initial 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 to be reported. These respondents also generally considered that although applying IFRS 16 may be costly for many entities, they have no reason to doubt that, overall, the benefits of IFRS 16 will outweigh its costs.

49 However, one Standard Setter considered that IFRS 16 was not an improvement over IAS 17 as the latter was deemed to provide more relevant information in particular by distinguishing between operating and finance leases, and straight lining operating lease expenses rather than front loading of expenses under IFRS 16.

50 Some respondents highlighted the level of judgement required by IFRS 16 in some areas although, overall, that level was not such that it would be impracticable to apply the requirements. For instance, assessing whether an arrangement contains a lease or how and for what purpose the asset is being used or the degree of the "involvement in the design" of the asset could be challenging in industries such as Telecom and Energy.

51 Regarding the potential effects of IFRS 16 on financial stability and the behaviour of stakeholders, the following input was provided:

(a) One respondent considered that the level of transparency could help promote long-term financial stability in the EU. This respondent observed that improving investor protection and promoting financial stability can only be achieved when all users on a regulated market, including SMEs, are subject to the same requirements. For that reason, it was important that SMEs that are listed on a regulated market fully apply IFRS 16.

(b) One respondent assessed that it was unlikely that IFRS 16 endangers financial stability in Europe as recognition of leases will provide both preparers and users of financial statements with more meaningful information about the gearing of companies that apply IFRS and will bring potential issues to light at an earlier stage. This respondent highlighted that some users were currently using the information in the notes to estimate liabilities arising from off-balance sheet debt, but noted that such estimations could be inaccurate due to the limited information available.

EFRAG Secretariat analysis of the feedback received and how it may inform the endorsement advice

52 Overall the feedback received from constituents is consistent with previous views expressed by the different stakeholders in the development of the standard. In particular, the EFRAG Secretariat notes the broad support from the users' community at large for the new guidance.

53 The EFRAG Secretariat notes that most of the issues reported by constituents (mostly preparers and leasing associations) have been already included in the drafting of the Preliminary Consultation Document including the extent of costs for preparers, the extent of judgement required to apply IFRS 16 and some identified limitations.

54 In its preliminary views, EFRAG agrees that IFRS 16 includes some areas in which limitations exist with regard to relevance, reliability and/or comparability (e.g. the recognition exceptions for short-term leases and to leases of low-value assets, intragroup subleases and the practical expedient permitting lessees not to separate non-lease components from lease components). However, it was assessed that these exceptions and expedients helps to reduce costs and complexity, especially for preparers and constitutes 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.

55 Further it is not within the remit of EFRAG's role to suggest 'a better standard' to European Commission but only to assess the issued standard (as proposed by some on the application of the substitution right principle or the low-value asset threshold). In the Preliminary Consultation Document, EFRAG has concluded that identified limitations do not prevent IFRS 16 from overall meeting the said qualitative characteristics and not being contrary to the true and fair view principle and the EFRAG Secretariat has not identified reasons to revise that assessment based on the feedback received.

56 The EFRAG Secretariat also observed the difficulty to have a quantitative assessment of the one-off and ongoing costs of applying IFRS 16 although it is generally acknowledged that these costs would be high for some. In that regard, we expect more input to be provided by the extensive outreach and interviews conducted by the economic consultant commissioned by EFRAG.

57 The EFRAG Secretariat however considers that the forthcoming draft endorsement advice could be further improved by:

(a) Reporting 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. The issue was raised at the EFRAG Board meeting in October and shared with representatives of the European Commission but could be given more prominence by being inserted in the cover letter to the Endorsement Advice;

(b) Reporting the concerns expressed by some respondents as the need to clarify the effects of the new standards on regulatory capital requirements, although assessing the effects of the new standard on such requirements is not part of EFRAG's assessment; and

(c) Revising the assessment of costs for lessors to clarify that, although lessor accounting is substantially unchanged, a lessor's cost structure could still be impacted indirectly by the need to provide more information to lessees.

Appendix 1 – List of respondents to the Preliminary Consultation Document

Respondent	Country/ Region	Type
KIBE SA	Belgium	Preparer
J Wrigley - Fidelity International	UK	User
ICAEW	UK	Professional organisations
ESMA	Europe	Regulators
SNLVLD	France	Leasing Association
FEE	Europe	Professional organisations
ICAC	Spain	Standard Setter
ANC	France	Standard Setter
Leaseurope	Europe	Leasing Association
ASSILEA	Italy	Leasing Association
OIC	Italy	Standard Setter
Air France-KLM	France	Preparer
Volkswagen	Germany	Preparer
Deutsche Telekom	Germany	Preparer
VNA - Dutch Association of Car Leasing Companies	The Netherlands	Leasing Association
Swedish Enterprise Accounting Group	Sweden	Preparers organisation
Quoted Companies Alliance	UK	Preparers organisation
ASCG	Germany	Standard Setter
SAP	Germany	Preparer
Munich Re	Germany	Preparer
Lithuanian Authority of Audit, Accounting, Property Valuation and Insolvency Management	Lithuania	Standard Setter
ASF - Association Française des Sociétés Financières	France	Preparers organisations
Confidential	Germany	Preparer
ESBG - European Retail and Banking Group	Europe	Preparers organisations
CRUF Global	International	Users organisation
Engie	France	Preparer
AFRAC	Austria	Standard Setter
NVL - Dutch Leasing Association	The Netherlands	Leasing Association
BNPP	France	Preparer
FBF - Federation Bancaire Francaise	France	Preparers organisation
FRC - Financial Reporting Council	UK	Standard Setter
EFFAS - European Federation of Financial Analysts Societies	Europe	Users organisation