

PAPER FOR PUBLIC EFRAG BOARD MEETING

This paper provides the technical advice from EFRAG TEG to the EFRAG Board, following EFRAG TEG's public discussion. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board. This paper is made available to enable the public to follow the EFRAG's due process. Tentative decisions are reported in EFRAG Update. EFRAG positions as approved by the EFRAG Board are published as comment letters, discussion or position papers or in any other form considered appropriate in the circumstances.

IFRS 16 LEASES
Draft Endorsement Advice**NOTE TO CONSTITUENTS**

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the endorsement of IFRS 16 *Leases*. EFRAG has been carrying out an assessment of IFRS 16 against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been developing responses to specific issues raised in the letter from the EC dated 9 June 2016.

EFRAG is conducting the consultation on its endorsement advice in two phases.

1 Preliminary Consultation Document (consultation closed 8 December 2016).

During this consultation, EFRAG sought views on the following:

- (a) Whether IFRS 16 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raises no issues regarding prudent accounting is not contrary to the true and fair view principle (see Appendix 2 of the attached draft endorsement advice).
- (b) Whether IFRS 16 would improve financial reporting, compared to IAS 17 and the associated Interpretations it replaces and that the lack of convergence with the equivalent standard on leases in US GAAP would not put European entities at a competitive disadvantage (see relevant components of Appendix 3).

2 Draft Endorsement Advice (consultation closes on **DATE)**

The draft endorsement advice reflects:

- (a) Comments from constituents on the Preliminary Consultation Document;
- (b) Responses to the user questionnaire;
- (c) Additional research undertaken in respect of the impact of IFRS 16 on SMEs;
- (d) Findings from the economic study commissioned by EFRAG; and
- (e) Expert advice from the European Central Bank and the European Banking Authority in specific areas of those organisations' expertise.

EFRAG is now seeking comments on its draft endorsement advice. EFRAG welcomes comments on any part of the draft endorsement advice, but notes that the Preliminary Consultation Document included a complete draft of Appendices 1 and 2 which is largely unchanged in this document. Accordingly, EFRAG is primarily interested in comments on specific components of Appendix 3 of the draft endorsement advice, along with supporting evidence if applicable.

Comments should be submitted by [date] by using the 'Express your views' page on EFRAG website or by clicking [here](#)

Your details

1 Please provide the following details:

- (a) Your name or, if you are responding on behalf of an organisation or company, its name:

- (b) Are you a:

Preparer User Other (please specify)

- (c) Please provide a short description of your activity:

- (d) Country where you are located:

- (e) Contact details, including e-mail address:

Appendix 3 of the draft endorsement advice

Potential effects on stakeholders' behaviours

- 2 Do you agree with EFRAG's discussion and preliminary conclusions (Appendix 3, paragraphs 28-57)?

Yes No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Impact of IFRS 16 on the leasing industry

- 3 Do you agree with EFRAG's discussion and preliminary conclusions (Appendix 3, paragraphs 58-67)?

Yes No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

*IFRS 16 Leases
Note to Constituents and Invitation to Comment*

Impact of IFRS 16 on SMEs

- 4 Do you agree with EFRAG's discussion and preliminary conclusions (Appendix 3, paragraphs 68-103)?

Yes No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Costs and benefits of applying IFRS 16

- 5 EFRAG has received some information that quantifies the costs of applying IFRS 16. Are you able to provide further quantification of the costs and/or benefits of applying IFRS 16? (Appendix 3, paragraphs 132-214)?

EFRAG's Draft Letter to the European Commission Regarding Endorsement of IFRS 16 Leases

Olivier Guersent
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

xx March 2017

Dear Mr Guersent

Adoption of IFRS 16 Leases

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on IFRS 16 *Leases* (IFRS 16), which was issued by the IASB on 13 January 2016.

IFRS 16 has been subject to substantial comment and debate over the decade of its development. Two Exposure Drafts were issued and EFRAG commented on both. EFRAG also undertook numerous specific outreaches with a wide range of stakeholders and considered all views expressed. Appendix 4 summarises the outreach activities conducted by EFRAG since 2013.

The objective of IFRS 16 is to improve the accounting for leases, with the most notable change being the removal of the distinction between operating and finance leases in the financial statements of lessees leading to the recognition by lessees of assets and liabilities resulting from former operating leases in addition to the current recognition of assets and liabilities under finance leases.

IFRS 16 becomes effective for annual periods beginning on or after 1 January 2019, with earlier application permitted. A description of the changes introduced by IFRS 16 is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have assessed whether IFRS 16 would meet the technical criteria for endorsement, in other words whether IFRS 16 would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and not be contrary to the true and fair view principle. We have also assessed whether IFRS 16 would be conducive to the European public good.

To support our assessment, we commissioned a study from an economic consultancy ('the economic study commissioned by EFRAG') as an input to this endorsement advice. The aim of the study was to provide input into EFRAG's analysis of potential changes in the behaviour of preparers, investors and lenders and the impact of any such changes on the European economy, including the impact of IFRS 16 on the leasing industry and the costs and benefits that would arise if IFRS 16 were to be endorsed.

We also relied on the input provided by the European Central Bank and the European Banking Authority on their areas of expertise, being the effects of IFRS 16 on financial stability and the interaction of IFRS 16 with prudential requirements of banks.

A summary of the results of these assessments is provided below.

Does IFRS 16 meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that IFRS 16 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raises no issues regarding prudent accounting. EFRAG has identified some limitations with regard to relevance, reliability and/or comparability but has assessed that they 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. These limitations would not prevent IFRS 16 from meeting the said qualitative characteristics.

EFRAG has also assessed that IFRS 16 does not create any distortion in its interaction with other IFRS and that all necessary disclosures are required. Therefore, EFRAG has concluded that IFRS 16 is not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Is IFRS 16 conducive to the European public good?

EFRAG has assessed that IFRS 16 would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that IFRS 16 could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that adopting IFRS 16 is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

Issues raised in your request for advice

You asked us to provide our views on certain specific matters (Annex 2 of your request letter). We summarise our responses below.

General

We have assessed that the definition of a lease appropriately identifies those contracts that convey control of the right to use an asset for a fixed period of time.

We acknowledge 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 outreach conducted by EFRAG has not identified that the judgement required in this area is more complex than judgements required by other IFRS Standards (see Appendix 2 paragraphs 179 and 227-229).

We also acknowledge that, 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. However, we have assessed that a symmetrical approach to lessor accounting involving the partial derecognition of assets owned by lessors, would be complex and costly to apply for minor presentation benefits. Feedback from users shows that the requirements in IAS 17 are well understood and users have indicated that they do not currently adjust lessors' financial statements for the effects of leases, indicating that the lessor accounting model in IAS 17 provides users with adequate information (see Appendix 2 paragraph 76).

Improvement to financial reporting

We have assessed whether IFRS 16 would contribute to improving financial reporting. In particular, we have assessed that recognition of lease assets and liabilities provides more transparent and comparable information on lessees' financial leverage. Recognition provides information on the stewardship of management by providing information about the assets available to the entity and the associated liabilities. Further, recognition of assets and liabilities arising from leases has predictive value in that the transparency provided assists users to assess the entity's future cash inflows from use of the leased asset, future cash outflows from the lease liability and to better understand the entity's capital employed (see Appendix 3 paragraphs 5-27).

Potential effects on stakeholders' behaviour

We have assessed the potential effects on stakeholders' behaviours, including lessees, users of financial statements, lessors and other lenders, (see Appendix 3 paragraphs 28-57). We note that some lessees may seek changes to their contract terms and conditions and that lessors may be requested to provide lessees with more information than in the past. However, we do not anticipate that, overall, IFRS 16 will have major deleterious effects on the leasing industry or to entities' access to and pricing of leasing as a source of finance.

Potential effects on competitiveness (including SMEs)

We have considered how IFRS 16 could affect small and medium-sized entities (SMEs). We have not found evidence that SMEs would be materially adversely or disproportionately affected by any changes resulting from IFRS 16 (see Appendix 3 paragraphs 68-103).

We have also analysed differences between IFRS 16 and its US GAAP equivalent and assessed that EU entities would not be at an overall disadvantage in relation to their US competitors (see Appendix 3 paragraphs 114-131).

Potential effects on financial stability

Based on our own work and the input provided by the European Central Bank, we have not identified evidence that indicates that IFRS 16 would pose a significant risk to financial stability in Europe.

IFRS 16 may enhance market confidence by better reflecting the leverage of lessees and promoting a forward-looking recognition of risks by providing detailed guidance on the reassessment of lease liabilities with early recognition of changes in the debt of the reporting entity. IFRS 16 is not expected to significantly change credit conditions of lessees. (see Appendix 3 paragraphs 104-113).

Cost-benefit analysis

We have considered the one-off and ongoing costs of implementing IFRS 16 and have concluded that, in general, IFRS 16 reaches an acceptable cost-benefit trade-off between the benefits to the European economy of greater transparency and better information for decision-making and the costs, which will mainly fall on lessees (see Appendix 3 paragraphs 132-214).

Other matters for your consideration

Timing of the endorsement process

Some constituents have indicated to EFRAG that it is very important to them that IFRS 16 is endorsed in a timely manner so as to facilitate early application of IFRS 16, in order to transition at the same time as IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 is effective from 1 January 2018. These constituents noted that the cost of implementation of IFRS 16 would be significantly increased if they are not able to transition to both Standards at the same time.

Effects on regulatory capital requirements of banks

Some constituents have expressed concerns about the need to clarify the interactions of IFRS 16 with regulatory capital requirements for banks. These constituents emphasised the lack of clarity about the treatment of the right-of-use asset for regulatory capital purposes and, in particular, its effects on the determination of solvency and leverage ratios.

The European Banking Authority has advised EFRAG that its preliminary analysis suggests that overall IFRS 16 would not raise significant challenges related to bank regulation and the impact of IFRS 16 on own funds and leverage ratios of banks was estimated to be of rather limited significance.

Our advice to the European Commission

As explained above, we have concluded that IFRS 16 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, leads to prudent accounting, and that it is not contrary to the true and fair view principle. We have also concluded that IFRS 16 is conducive to the European public good. Therefore, we recommend IFRS 16 for endorsement without further delay.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

CONTENTS

Does IFRS 16 meet the IAS Regulation technical endorsement criteria?	5
Is IFRS 16 conducive to the European public good?	5
Issues raised in your request for advice	5
Other matters for your consideration	6
Timing of the endorsement process	6
Effects on regulatory capital requirements of banks	6
Our advice to the European Commission	7
Appendix 1: Understanding the changes brought about by IFRS 16 Leases	11
Why is the IASB changing lease accounting?	11
How have the issues been addressed?	11
What has changed?	12
General features	12
Lease accounting by lessees	13
Lease accounting by lessors	14
Specific transactions	14
Presentation and disclosure	15
When does IFRS 16 become effective?	16
Transition requirements	16
Lessees	16
Lessors	16
Practical expedients	16
Sale and leaseback transactions	16
Appendix 2: EFRAG's technical assessment on IFRS 16 against the endorsement criteria	17
Summary	17
Does the accounting that results from the application of IFRS 16 meet the technical criteria for endorsement in the European Union?	17
Relevance	19
Definition and identification of a lease	19
Lessee accounting	21
Lessor accounting	28
Overall conclusion on relevance	30
Reliability	30
Lessee accounting	31
Lessor accounting	35
Overall conclusion on reliability	36
Comparability	36
Will the requirements in IFRS 16 be interpreted in a consistent manner?	37
Is the guidance in IFRS 16 adequate on all significant matters within its scope?	40
Does IFRS 16 include exemptions and practical expedients that could impair comparability?	42
Transition requirements	42

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission

Overall conclusion on comparability	42
Understandability	43
Does the single accounting model for lessees provide understandable information?	43
Do the exemptions and practical expedients in IFRS 16 introduce undue complexity?	44
Do the presentation and disclosure requirements result in understandable information?	44
Overall conclusion on understandability	45
Prudence	45
Recognition of liabilities arising from lease contracts.....	45
Initial measurement of right-of-use assets and the lease liabilities by lessees.....	46
Subsequent measurement of right-of-use assets by lessees	47
Use of fair value as a measurement basis for certain right-of-use assets	47
Accounting for sale and leaseback transactions	47
Overall conclusion on prudence	48
True and fair view principle	49
Overall conclusion	50
Appendix 3: Assessing whether IFRS 16 is conducive to the European public good.....	51
Summary	51
Is the financial reporting required by IFRS 16 an improvement over that required by IAS 17?	52
Accounting by lessees.....	52
Recognition of a right-of-use asset and a lease liability for all leases.....	52
Presentation and disclosure	52
Adequacy of the guidance on all significant matters within its scope	53
Accounting by lessors	53
Sale and leaseback transactions.....	53
Requirements that may limit usefulness	54
Options, exemptions and practical expedients.....	54
Level of judgement required by some requirements	54
Conclusion.....	54
Potential effects on stakeholders' behaviours	55
Approach to assessing the potential effects on stakeholders' behaviours.....	55
Quantitative impact of IFRS 16 on financial statements	55
Impact of financial statement changes on behaviour of users	57
Impact of financial statement changes on behaviour of lessees.....	58
Switching to other forms of finance	58
Changing the lease term or the form of payment.....	59
Impact of IFRS 16 on the leasing industry	61
Approach to assessing the impact of IFRS 16 on the leasing industry.....	61
Impact of IFRS 16 on SMEs.....	63
Assessing the extent to which SMEs are likely to apply IFRS 16	63
Assessing whether IFRS 16 is proportionate to SMEs	64
Whether the administrative burden will be proportionally greater for SMEs	64

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission

Assessing whether the accounting impact will be proportionally greater for SMEs	66
Assessing whether the SME sector has a whole would be adversely affected by changes in the pricing and availability of leases	67
Conclusion on impact on SMEs	67
Is IFRS 16 is likely to endanger financial stability in Europe?	68
Approach to assessing whether IFRS 16 is likely to endanger financial stability	68
Potential effects on competitiveness	70
Lack of full convergence between IFRS 16 and the equivalent US GAAP pronouncement.....	70
Expense recognition pattern.....	70
Presentation of lease liabilities	71
Ongoing application costs	71
Conclusion.....	72
Costs and benefits of applying IFRS 16	73
Introduction.....	73
Costs for preparers.....	73
Cost for lessors.....	73
Cost for lessees.....	73
One-off costs for lessees.....	74
Ongoing costs for lessees	77
Quantification of one off-costs and ongoing costs	79
Costs for users	80
One-off costs	80
Ongoing costs.....	81
Benefits for users and preparers	81
Benefits for users.....	81
Benefits for preparers	82
Conclusion on the costs and benefits of IFRS 16	83
Appendix 4: Summary of EFRAG's Outreach Activities	84

Appendix 1: Understanding the changes brought about by 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:
 - (a) 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.
 - (b) 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.
 - (c) 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 comparable and 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 exemptions (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.

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. 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 but does not require entities 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

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

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.

Separating components of a contract

- 13 Both IFRS 16 and IAS 17 require the separation of contracts between the lease and any non-lease components.
- 14 For lessees, IFRS 16 requires 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.

Lease modifications

- 16 Unlike IAS 17, IFRS 16 contains guidance for both lessee and lessor on modifications to leases. For lessees, and lessors of 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 lessors with 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 when the interest rate implicit in the lease cannot be readily determined.
- 21 Lease liabilities are subsequently measured at amortised cost, similarly to financial liabilities. 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.

Lease accounting by lessors

- 25 IFRS 16 carries forward lessor accounting substantially unchanged from IAS 17. One 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.
- 26 IFRS 16 also requires additional information about a lessor's leasing activities and in particular the exposure to certain risks.

Specific transactions

Sale and leaseback

- 27 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.

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

Subleases

- 30 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

- 31 IFRS 16 requires that lessees present payments of the principal portion of lease liabilities within financing activities in the statement of cash flows. Payments for the interest portion are presented within 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. Under IAS 17, lessees presented cash outflows on operating leases within operating activities. IFRS 16 will therefore increase reported net operating cash flows and decrease reported net financing cash flows compared to the amounts reported under IAS 17.
- 32 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'*.
- 33 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.

- (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.
- 34 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?

- 35 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

- 36 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

- 37 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

- 38 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.
- 39 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

- 40 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.
- 41 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.

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

Summary

- 1 This Appendix contains EFRAG's assessment of IFRS 16 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 exceptions and recognition exemptions) 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 Standards (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:

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.

- 7 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).
- 8 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 225-232, 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.
- 9 EFRAG's assessment of 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 12–90;
 - (b) reliability: paragraphs 91–131;
 - (c) comparability: paragraphs 132–181;
 - (d) understandability: paragraphs 182–200;
 - (e) whether overall IFRS 16 leads to prudent accounting: paragraphs 201–224; and
 - (f) whether IFRS 16 would lead to financial reporting that is not contrary to the true and fair view principle: paragraphs 225–232.
- 10 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 IFRS 16 and the two preceding Exposure Drafts);
 - (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.
- 11 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. However, 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.

Relevance

- 12 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.
- 13 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 10:
- (a) Definition and identification of a lease;
 - (b) 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;
 - (c) Lessor accounting:
 - (i) Sublease arrangements; and
 - (ii) Disclosures.

Definition and identification of a lease

- 14 During the development of IFRS 16, concerns were raised that the definition of a lease might incorrectly scope services into the definition of a lease or exclude contracts that are leases from the scope of the Standard.
- 15 EFRAG acknowledges that the requirements in IFRS 16 for a lessee to recognise assets and liabilities for most leases on the balance sheet places significant emphasis on the definition of a lease and supporting guidance. In contrast, under IAS 17 a lessee's accounting for an operating lease was similar to the accounting for many contracts for the procurement of services and the distinction between the two types of leases (finance and operating) was typically more critical than the distinction between leases and services. For this reason, during the development of the Standard, EFRAG repeatedly stressed the importance of having a definition that would draw the appropriate distinction between leases and service agreements and be sufficiently understandable to be applied in a consistent manner. While the IASB

- has made significant improvements to the definition and the related guidance, not all of EFRAG suggestions – including for instance developing a positive definition of service – have been taken up in IFRS 16.
- 16 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 These conditions are similar to the definition of a lease in IAS 17 as interpreted in IFRIC 4 *Determining whether an Arrangement contains a Lease*. However, the IASB has introduced various modifications and clarifications to address some of the concerns expressed and issues identified by constituents about the application of IFRIC 4. For example, when identifying a lease IFRS 16 does not place the same emphasis as IFRIC 4 on the pricing arrangement in the contract. IFRS 16 also includes additional guidance and examples on assessing whether a contract conveys the right to control an underlying asset (which is the case when the conditions in paragraphs 16(b) and (c) above are met).
- 18 Each of the conditions in paragraph 16 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. Also refer to paragraphs 140-143 in the section '*Comparability*' for a discussion on the judgement involved in determining whether the supplier has a substantive substitution right. 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: 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 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.

- 20 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

- 21 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 notes². It follows that the requirement in IFRS 16 for a lessee to recognise right-of-use assets and lease liabilities arising under leases (as distinct from note disclosure or cash flow disclosures as is required under IAS 17) is critical to the provision of relevant information.
- 22 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.
- 23 The substance of a lease is that the lessee acquires the economic benefits of the use of the underlying asset in return for assuming an obligation to pay for that right. This is because, once the asset is made available for use by the lessee, the lessor is unable to retrieve or otherwise use the underlying asset for its own purposes despite being its legal owner. The lessee has the ability to determine how to use the underlying asset and, thus, how it generates future economic benefits from that right of use. EFRAG considers that transactions and other events that are accounted for and presented in accordance with their substance and not merely with their legal form provide more relevant information to users.
- 24 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.
- 25 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

- 26 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. An entity is permitted, but not required, to apply IFRS 16 to leases of other intangible assets. This scope exemption could reduce the relevance of information provided by applying IFRS 16 by omitting from the financial statements assets controlled by an entity and the associated liabilities arising from leases of some types of asset.

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

- 27 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. However, a majority of the constituents that responded to the question on this point in EFRAG's Preliminary Consultation Document indicated that leases of intangible assets (other than those within the scope of IAS 38) are not common or are immaterial.
- 28 EFRAG therefore concludes that the scope exemption referred to in paragraph 26 is not expected to have a significant impact as these type of leases are not common in practice. The benefits of including such leases in the scope of IFRS 16 may not justify the associated costs. 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

- 29 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) 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.
- 30 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.
- 31 However, EFRAG assesses that allocating the contracts based on relative stand-alone selling prices has the consequences 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.
- 32 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).
- 33 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

- 34 EFRAG does not generally support introducing exemptions or practical expedients because they may limit the relevance of financial information. However, EFRAG also acknowledges that there is a trade-off between potential limitations in relevance and the reductions in complexity and cost that such exemptions and practical expedients give preparers.

- 35 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.
- 36 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.
- 37 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.
- 38 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.
- 39 EFRAG also observes that no specific disclosures are 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.
- 40 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

- 41 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.
- 42 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.
- 43 EFRAG observes that IFRS 16 requires a lessee to consider all relevant facts and circumstances that create an economic incentive to exercise, or not to exercise, an option. IFRS 16 also includes extended illustrative guidance on the types of factors that should be considered in making the assessment.

- 44 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 reasonably certain to be exercised could distort the depiction of the financial position and 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.
- 45 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.
- 46 EFRAG assesses that including 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) in the measurement of lease liabilities provides relevant information. These payments represent the lessee's unavoidable obligation based on conditions at the applicable date.
- 47 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).
- 48 Some might consider that a comparable level of uncertainty exists in assessing whether renewal or termination options are 'reasonably certain' to be exercised, noting that IFRS 16 requires such options to be assessed (see paragraphs 41 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.
- 49 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.
- 50 On that basis, 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 that, under such circumstances, the exclusion of variable payments might decrease the relevance of information.
- 51 Finally, EFRAG observes that additional disclosures are required for payments that are not included in 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).

52 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

53 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 in the right-of-use asset 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.

54 Subsequent measurement of the lease liability is on an amortised cost basis, subject to the requirements on lease modifications discussed in paragraphs 60–61, 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.

55 EFRAG acknowledges that, in principle, users of financial statements receive more relevant information if lessees reassess whether the exercise of extension, termination and purchase options is reasonably certain 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.

56 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 and that affects whether the lessee is reasonably certain to exercise, or not to exercise, an option.

Other measurement models for the right-of-use asset

57 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*.

58 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.

59 IFRS 16 permits but does not require 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

60 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.

- 61 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

- 62 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 generic of sale and leaseback transactions that prevent the accounting for a sale by the seller-lessee as required by IFRS 15. In such a case, 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. In its endorsement advice, EFRAG assessed that IFRS 15 provided relevant information for such transactions. EFRAG accordingly considers that the requirements in IFRS 16 on sale and leaseback transactions also provide relevant information.

Presentation

- 63 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.
- 64 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).
- 65 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. The recognition of an interest expense relating to the lease liability is consistent with the financing nature of that liability. The classification of the cash outflows is similarly consistent with nature of the liability. Likewise, the recognition of a depreciation expense is consistent with the non-financial nature of the right-of-use asset. In EFRAG's view, cohesion between the primary statements enhances the relevance of information including its use in calculating of key metrics such as return on capital employed and leverage ratios.
- 66 Overall, EFRAG assesses that the presentation requirements in IFRS 16 result in the provision of relevant information.

Disclosures

- 67 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. It identifies two-tiers 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.
- 68 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.
- 69 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.
- 70 EFRAG's overall assessment is that the disclosure requirements result in the provision of relevant information.

Transition requirements

- 71 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.
- 72 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.
- 73 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 continued to be treated as leases (or vice versa). Based on the feedback received in response to its Preliminary Consultation Document, EFRAG expects that IFRS 16 will change the outcome of the assessment of whether a contract is, or contains, a lease only in limited circumstances. 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.
- 74 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.
- 75 Overall, EFRAG assesses that the transition requirements result in the provision of relevant information.

Lessor accounting

Asymmetry between lessee and lessor accounting

- 76 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

- 77 Similar to its assessment for lessee accounting (see paragraph 46-52), 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.
- 78 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.
- 79 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.
- 80 As a result, EFRAG assesses that these requirements of IFRS 16 provide relevant information.

Sublease arrangements

- 81 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.
- 82 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.
- 83 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.
- 84 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).
- 85 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 18(a), 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.
- 86 If the full capacity is sublet, some may argue that the economic position of the intermediate lessor is comparable whether the full capacity is sublet to one or to several sub-lessees for the remainder of the head lease term. In both cases 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

- 87 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 leased assets are often a lessor's primary risks. These risks can affect the profitability of the leases. The disclosure will therefore provide useful information about lessor's risk exposures and will enable users to evaluate the risks associated with residual interests 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

- 88 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 and exemptions) will result in relevant information.
- 89 The substance is that the lessee acquires the rights to the economic benefits from the use of the asset, in return for assuming an obligation to pay for those rights. The lessee has the ability to determine how to use the underlying asset and, thus, how it generates future economic benefits from that right-of-use. EFRAG considers that:
- (a) 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.
 - (b) Recognition of a lease liability provides information about obligations to make future cash outflows and, hence, enhances transparency about an entity's financial leverage.
- 90 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 34-40); the exclusion of variable lease payments based on usage or performance (paragraphs 46-52) and the determination of the lease term, in particular the subsequent reassessment of extension, termination and purchase options (paragraphs 55-56). 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

- 91 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.

- 92 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.
- 93 In its assessment of reliability, EFRAG has identified the following topics based on the criteria in paragraph 10:
- (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; and
 - (ii) Disclosures.

Lessee accounting

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

- 94 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.
- 95 In a contract for goods or services, a customer is required to recognise a liability when the supplier has performed its obligation and the customer has an obligation to transfer resources to the supplier in exchange.
- 96 In the case of a lease, the lessor has performed when it provides the lessee with control over the use of the underlying asset for the term of the lease and does not have the ability to unilaterally revoke it. The lessor may provide other services over the term of the lease, but such services are generally treated as a separate unit of account if distinct from the right to use the underlying asset.
- 97 During the lease term, as defined under IFRS 16, the lessee does not have the ability to unilaterally terminate the lease and return the underlying asset. The lessee also has an obligation to make payments. EFRAG agrees that the conditions to recognise a liability are met at commencement of the lease term.
- 98 Introducing the right-of-use concept relating to operating leases emphasises the substance of the transaction. This is justified, in EFRAG's view, because:
- (a) 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.
 - (b) 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

- 99 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.
- 100 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

- 101 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 an assessment of economic incentives provides a threshold that is more objective and practical than an assessment 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.
- 102 As discussed above in the section on relevance (paragraphs 45 and following), 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 indices or rates. EFRAG assesses that this provides reliable information as it avoids the potentially high levels of uncertainty inherent in predicting future changes in the index or rate.
- 103 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. 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.
- 104 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

- 105 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. Most preparers have indicated to EFRAG that they will consider using the recognition exemptions for leases of low-value and for short-term leases. However, a majority of preparers do not expect that the exemption for short-term leases will provide significant cost relief. This is due to the fact that relatively few leases have a term of twelve months or less taking into account renewal options that are reasonably certain to be exercised.
- 106 Although leases of low-value assets are likely to be immaterial, EFRAG observes 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. However, a majority of users indicated to

EFRAG that they do not expect to adjust for the recognition exemptions applicable to leases of low-value and for short-term leases.

- 107 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 presentation of 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

- 108 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.
- 109 Subsequent measurement of the lease liability on an amortised cost basis, subject to the adjustments due to lease modifications (discussed below in paragraphs 119–120) also provides a faithful depiction of the unwinding of the lessee's obligation to pay the amounts specified in the contract.
- 110 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.
- 111 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.
- 112 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.
- 113 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

- 114 As set out in paragraphs 57–59 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 in the same class of property, plant and equipment to which the lessee already applies the revaluation model in IAS 16.
- 115 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.
- 116 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.
- 117 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 remaining term of the lease, the lessee would have to make a number of assumptions and would 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.
- 118 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

- 119 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.
- 120 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 (for instance when a lease is modified to terminate the right to use one or more underlying assets or to shorten the contractual lease term), the lessee remeasures the lease liability at the effective date of the modification using a revised discount rate. Furthermore, the lessee decreases the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease. Any gain or loss relating to the partial or full termination is recognised in profit or loss. EFRAG assesses that 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

- 121 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.

- 122 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

- 123 As discussed above in the section on relevance (paragraphs 67–70), 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.
- 124 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

- 125 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.
- 126 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

- 127 Similar to the assessment for lessees (see paragraphs 102-103), 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 rate provides reliable information. This is because the measurement considers only payments that are unavoidable under the lease agreement based on current conditions. The measurement does not require a prediction of (potentially highly uncertain) future changes in the index or rate.

Sublease arrangements

- 128 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 81-86.

Disclosures

- 129 As discussed above in the section on relevance (paragraph 87), 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.
- 130 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

- 131 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 105-107) and to the determination of lease term (see paragraphs 111-113). 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

- 132 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.
- 133 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.
- 134 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. This notion has been confirmed by a majority of users in response to EFRAG's Preliminary Consultation Document and associated User Questionnaire. Many users indicated that they currently make adjustments to entities' reported liabilities to reflect lease obligations and some users indicated that they also make adjustments to entities' reported assets in order to enhance comparability between entities.
- 135 Based on the criteria enumerated in paragraph 10, 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?

- 136 Application of IFRS 16 will be relatively simple in many cases and will 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.
- 137 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.
- 138 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);
 - (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);
 - (e) for lessees, determining the discount rate; and
 - (f) for lessors, determining whether a contract is an operating or a finance lease.

Determining whether a contract contains a lease

- 139 EFRAG has carried out specific field work with a number of preparers, across 13 industries and 9 jurisdictions, on the complexity of determining whether a contract is a lease. The context and findings of the fieldwork are described in more detail in a separate EFRAG Secretariat paper available [here](#)³.
- 140 In response to EFRAG's consultations, constituents generally indicated that they do not expect the definition of a lease and supporting guidance in IFRS 16 to result in extensive reclassifications of contracts between leases and service contracts.
- 141 Some constituents have commented that a significant amount of judgement is involved in applying the definition of a lease and supporting guidance in IFRS 16. EFRAG has heard that, in some industries the assessment may require a greater degree of judgement for certain types of contracts (in particular some constituents have mentioned the assessment becomes more complex when substitution rights

³ Source: EFRAG Secretariat paper *IFRS 16: Fieldwork on the definition of a lease* for the details of this outreach.

exist), especially when both the customer and the supplier make decisions about the use of an item.

- 142 IFRS 16 states that even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. This requires the entity to evaluate whether a supplier's substitution right is substantive based on the facts and circumstances at inception of the contract without considering future events that, at inception of the contract, are not considered likely to occur. IFRS 16 provides examples of future events that, at inception of the contract, would not be considered likely to occur.
- 143 IFRS 16 states that if the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.
- 144 EFRAG was not advised of any situations where the application of the relevant guidance in IFRS 16 would be excessively complex and beyond the level of judgement reasonably required by a principles-based standard.

Determining the lease term

- 145 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 the exercise or non-exercise of an option is reasonably certain requires consideration of all relevant facts and circumstances that create an economic incentive for the lessee to exercise that option.
- 146 Some constituents have commented that, although the reasonably certain threshold is not new, it becomes more important under IFRS 16 than under IAS 17 and also that it might be interpreted inconsistently. They observed that, under IFRS 16, judgements on lease terms may be needed more frequently and would have a greater effect with the recognition of lease assets and liabilities.
- 147 In response to EFRAG's Preliminary Consultation Document, some constituents (especially in the retail and car leasing industries) indicated that it may be difficult to assess the lease term in presence of multiple extension options that potentially make the lease term indefinite. A few constituents noted that IFRS 16 does not provide a time limit on which extension options to include.
- 148 EFRAG acknowledges that judgement is required to assess whether exercise of an option is reasonably certain, whether events or changes in circumstances that occur are significant and whether those events are within the control of the lessee. However, EFRAG notes that the reasonably certain threshold is a high hurdle, which should, at least to some extent, mitigate the concerns raised. Further, EFRAG considers that IFRS 16 provides specific examples of those factors to consider in determining the existence of economic incentives for the lessee, given the specific requirements of each lease contract. EFRAG also notes that IFRS 16 does not introduce new concepts relating to lease term determination and provides further guidance that 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.
- 149 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

- 150 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.

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

- 151 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.
- 152 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

- 153 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.
- 154 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 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

- 155 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.
- 156 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.
- 157 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?

158 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

159 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.

160 However, as mentioned above, EFRAG assesses that leases of intangible assets (other than the ones referred to in paragraph 26 above) are not frequent, in particular leases that are classified as finance leases in accordance with IAS 17. This has also been confirmed by constituents as stated in paragraph 27. Hence, there is no evidence that the optional application to leases of intangible assets 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

161 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.

162 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

163 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

164 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.

- 165 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 than 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.
- 166 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 comparability of financial information within an entity.

Presentation

- 167 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.
- 168 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 considers that this will also enhance comparability between entities that borrow to buy assets and those that lease similar assets.
- 169 IFRS 16 requires principal repayments on all lease liabilities to be included within financing activities in the statement of cash flows. Some constituents have observed that this represents a substantive change as cash flows from operating leases are classified within operating activities under IAS 17.
- 170 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. The lessee accounting model in IFRS 16 is based on the premise that leases create liabilities of a financing nature. These liabilities are presented on the balance sheet and in the statement of cash flows in a similar way, which helps users to perform meaningful ratio analyses.
- 171 Some may argue that IFRS 16 results in comparable presentation between leasing an asset and purchasing an asset financed by borrowings for balance sheet purposes, but not for cash flow presentation. This is because, when an entity purchases an asset and borrows from another party to finance the purchase, it would present an investing cash outflow for the purchase of the asset and a financing cash inflow relating to the borrowing. However, EFRAG observes that, given that the statement of cash flows presents actual cash flows, it is not possible to reflect a lease in the same way as purchasing an asset and borrowing funds.
- 172 Some may also question whether IFRS 16 would lead to similar presentation to a situation in which assets are purchased on deferred payment terms granted by the vendor. EFRAG observes that, although IAS 7 is explicit that cash payments to acquire tangible and intangible assets are classified as investing cash flows, no explicit guidance is provided in the situation of deferred payment terms. Accordingly,

some diversity may exist in practice with the result that IFRS 16 may result in comparability for cash flow presentation purposes in some cases but not in others.

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

- 173 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.
- 174 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.
- 175 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 (see paragraphs 37-40). As a result, EFRAG assesses that the operational benefits provide an adequate offset to the possible limitations in comparability.

Transition requirements

- 176 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.
- 177 EFRAG assesses that, as a consequence of paragraph 176(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.
- 178 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

- 179 IFRS 16 requires the exercise of judgement in a number of areas (including applying the disclosure requirements). Judgements are inevitable 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.

- 180 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 optional recognition exemption for leases of low-value assets, and the practical expedient to not separate non-lease components from lease components (see paragraphs 173-175); and
 - (b) the transition period and the immediately following periods, caused by the different transition options permitted (see paragraphs 176-178).
- 181 These limitations to comparability are however balanced against the overall relevance of the resulting information and the reduced cost and complexity for preparers.

Understandability

- 182 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.
- 183 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.
- 184 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.
- 185 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.
- 186 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?

- 187 The selection of a single or dual measurement model for lessees was the subject of substantial debate. 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.

- 188 EFRAG notes that, although IFRS 16 introduces some new concepts (such as right-of-use assets or in-substance fixed payments) it principally extends the well-understood accounting treatment currently applicable to 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.

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

- 189 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.
- 190 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.
- 191 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. 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.
- 192 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

- 193 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.
- 194 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.
- 195 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.

- 196 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.
- 197 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

- 198 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

- 199 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 number of exemptions to the general principles and practical expedients available both upon transition and on an ongoing basis. However, EFRAG has assessed that these exemptions and practical expedients would not impair understandability.
- 200 Therefore, EFRAG's overall assessment is that IFRS 16 satisfies the understandability criterion in all material respects.

Prudence

- 201 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.
- 202 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

- 203 By requiring the recognition of liabilities arising from all lease contracts (with limited exemptions) corresponding to the unavoidable payments to be made under the lease, IFRS 16 is consistent with the concept of prudence.

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

- 204 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.
- 205 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.
- 206 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.
- 207 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 48 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.
- 208 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.
- 209 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.
- 210 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.

Subsequent measurement of right-of-use assets by lessees

- 211 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.
- 212 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.

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

- 213 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.
- 214 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.
- 215 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.
- 216 As mentioned in paragraph 117, 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

- 217 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.
- 218 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.

- 219 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.
- 220 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.
- 221 If the sale consideration or leaseback rentals are not at market rates, and the transaction meets the requirements for a transfer in IFRS 15, 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 and any losses are 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.
- 222 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

- 223 EFRAG has concluded that:
- (a) the recognition of liabilities arising from all lease contracts (with limited exemptions and exceptions) is consistent with the concept of prudence;
 - (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;
 - (c) the requirement to measure right-of use assets at cost less accumulated depreciation and impairment (with some exemptions) is aligned with the requirement applicable to owned property, plant and equipment, which have been assessed to lead to prudent accounting;
 - (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 for and that the carrying amount of the asset is not misstated by the buyer-lessor.
- 224 Consequently, EFRAG has concluded that the application of IFRS 16 would lead to prudent accounting.

True and fair view principle⁴

- 225 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) requires appropriate disclosures that provide a complete and reliable depiction of an entity's assets, liabilities, financial position, profit or loss and cash flows.
- 226 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.
- 227 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.
- 228 EFRAG observes that IFRS 16 takes an economic substance approach to recognising assets and liabilities arising from leases. In doing so, IFRS 16 employs the notion of control. Many other recently issued IFRS Standards also employ the notion of control as a basis for the existence (and hence potential recognition) of an asset. It is therefore important to assess how the definition of control in IFRS 16 compares to the definition in other recent Standards such as IFRS 10 *Consolidated Financial Statements* and IFRS 15 *Revenue from Contracts with Customers*.
- 229 The essential elements in the notion of control in IFRS 16 - the power to take decisions and the entitlement to benefits is consistent across the three Standards:
- (a) IFRS 10 paragraphs 5-6 state that: '*An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.*'
 - (b) IFRS 15 paragraph 33 states that: '*Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.*'
 - (c) IFRS 16 paragraph BC117 states that: '*to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a 'benefits' element) but also the ability to direct the use of that asset (a 'power' element).*'
- 230 Although the three Standards rely on the same principle, the notion of control is articulated differently in the detailed guidance in response to the specific scope of each Standard. EFRAG considers that these differences in detail do not create a conflict between the principles.
- 231 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.

⁴ See also the non-paper of Commission Services DG FISMA Meeting of the Accounting Regulatory Committee on the True and Fair View Principle available [here](#).

232 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

233 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

- 1 EFRAG considered whether it would be conducive to the European public good⁵ 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 the impact of IFRS 16 on the leasing industry
 - (d) considered the impact of IFRS 16 on SMEs;
 - (e) considered whether IFRS 16 is likely to endanger financial stability in Europe
 - (f) 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; and
 - (g) evaluated the costs and benefits of endorsing IFRS 16.
- 2 Additional effects may arise as a result of possible future decisions made by Member States and countries in the EEA to introduce changes in their local accounting principles or tax legislation. Appendix 3 includes a brief description of some of these potential effects (see paragraphs 70 and following). However, EFRAG did not consider these in its assessment because they are of the exclusive competence of Member States and countries in the EEA. Furthermore, EFRAG is not in a position to assess the likelihood of these changes.
- 3 Overall, EFRAG has assessed that IFRS 16 would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that IFRS 16 could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that adopting IFRS 16 is conducive to the European public good.
- 4 The following paragraphs provide the bases for the above conclusions.

⁵ See also the non-paper of Commission Services DG FISMA Meeting of the Accounting Regulatory Committee on the European Public Good [here](#).

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

- 5 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

- 6 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 and exemptions). 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.
- 7 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.
- 8 Throughout its public consultations and outreaches, EFRAG has heard that a lessee model that recognises all assets and liabilities arising from lease contracts is useful to the broadest range of users of financial statements. Users benefit from lessees recognising interest on those liabilities in a similar way to other financial liabilities and the ability to perform meaningful ratio analyses. In particular, recognition of lease assets and liabilities provides better and more transparent information on lessees' financial leverage and assets and constitutes a better starting point for users' analyses of the financial position and financial performance of a lessee.

Presentation and disclosure

- 9 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 (as either operating or financing activities).
- 10 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 among in the three primary financial statements. EFRAG assesses that this provides 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.
- 11 Some constituents consider that a straight-line lease expense is a more faithful representation of pattern of consumption of the benefits from the use of the underlying asset. A lessee is likely to receive equal benefits from use of the underlying asset in each period. A straight-line cost recognition pattern would also be aligned to the payment pattern in most leases, when there are no down payments or rent holidays.

- 12 Users have generally indicated to EFRAG that a separate presentation of depreciation and interest expense provides useful information as users benefit from lessees recognising interest on those liabilities in a similar way to interest on other financial liabilities. This separate presentation provides a better starting point for their analyses of the financial performance of a lessee.
- 13 Financial reporting generally provides information on both expenses and cash flows without aiming to align the patterns of recognition. IFRS 16 is consistent with the principles throughout IFRS Standards and requires disclosures about both expenses and cash flows. This disclosure is identified as providing useful information about lease expenses and cash flows and enables users to forecasting future lease payments and associated expenses.
- 14 Furthermore, a lessee is required to disclose a maturity analysis for lease liabilities by applying the requirements of IFRS 7 *Financial Instruments: Disclosures*. EFRAG assesses that this provides 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.
- 15 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 than provided by IAS 17 because they are tailored to the lessee's specific portfolio of leases.

Adequacy of the guidance on all significant matters within its scope

- 16 As mentioned in Appendix 2, paragraph 158 in the assessment of the comparability criterion, IFRS 16 provides guidance on all of the most important issues covered in IAS 17 and provides more extensive application guidance in areas in which IAS 17 was considered to be inadequate. More extensive guidance is provided in particular on the definition of a lease; separating components of a contract; accounting for contract modifications; and variable consideration.
- 17 EFRAG assesses this to be an improvement that should result in IFRS 16 being applied more consistently than IAS 17.

Accounting by lessors

- 18 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.
- 19 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 175 below.

Sale and leaseback transactions

- 20 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 without recognising the associated liability 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.

Requirements that may limit usefulness

Options, exemptions and practical expedients

- 21 In its technical assessment contained in Appendix 2, EFRAG has assessed that the relevance of the information provided by IFRS 16 could be somewhat limited by a number of recognition and measurement options, exemptions or practical expedients available, both upon transition and on an ongoing basis.
- 22 In particular, IFRS 16 introduces optional recognition exemptions for short-term leases and leases of low-value assets and allows entities to not separate lease and non-lease components. 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 or, conversely, service components may be included in recognised amounts. There might also be some negative effect on comparability given that the use of the exemptions is optional.
- 23 For instance, the optional exemption 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. However, a majority of users have indicated to EFRAG that they did not expect to make adjustments for leases of low-value items or short term leases that are not recognised by a lessee; indicating that they do not expect any loss in information resulting from these two exceptions to be significant.
- 24 EFRAG notes 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. EFRAG has concluded that IFRS 16 reaches an acceptable trade-off between the completeness and faithful representation of information on the one hand and the costs and complexity of applying the requirements on the other hand.

Level of judgement required by some requirements

- 25 In its technical assessment contained in Appendix 2, EFRAG has acknowledged that application of some of IFRS 16's requirements may require significant judgement and may involve some additional complexity. Such requirements include determining whether a contract contains a lease, assessing the lease term or the discount rate (see Appendix 2 paragraph 179). EFRAG notes however that applying IAS 17 also requires the use of judgement in areas such as the distinction between finance and operating leases.
- 26 EFRAG has assessed that the level of judgement required by IFRS 16 is not so exceptional in nature that it would be impracticable for entities to apply its requirements (and that the extensive application guidance included in IFRS 16 provides the relevant framework for the exercise of judgement). EFRAG does however acknowledge that the exercise of judgement can increase the risk of diversity in practice, at least over the first few years of application which would, in turn, reduce the usefulness of the resulting information.

Conclusion

- 27 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.

Potential effects on stakeholders' behaviours

Approach to assessing the potential effects on stakeholders' behaviours

- 28 EFRAG has sought to obtain evidence to enable an estimate to be made of the nature and scale of potential effects of IFRS 16 on the behaviour of the main groups of stakeholders.
- 29 The approach has involved desktop research, primary data gathering, and data analysis. The economic study commissioned by EFRAG provided a significant part of the evidence base. The primary data gathering in that study involved market research with [156]⁶ lessees and [90] lenders/lessors interviewed and additional stakeholder interviews.
- 30 The most direct impact of IFRS 16 would be to change the financial statements of entities that will apply the Standard, i.e. to require accounting adjustments. Behavioural effects may then flow from those accounting adjustments (or from efforts to reduce or avoid such adjustments).
- 31 Financial reporting and capital market data was used to describe the scale of accounting adjustments (i.e. estimating how balance sheets and profitability could be affected by IFRS 16) and also to test the current debt capital market treatment of operating leases. 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

- 32 EFRAG conducted a study⁷ 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.
- 33 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 7.6 billion Euro⁸.
- 34 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.
- 35 The simulation is only illustrative and will not be identical to the effect of the initial application of IFRS 16 due to the following:

⁶ All figures between square brackets are provisional and based on the draft report of the economic consultancy commissioned by EFRAG. Figures will be revised based on the final report.

⁷ Source: EFRAG Secretariat paper *IFRS 16 Leases: Quantitative assessment of accounting impact* available [here](#).

⁸ A separate quantitative assessment was prepared for small and medium-sized entities. See Section *Impact of IFRS on SMEs*.

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

- (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; and
 - (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.
- 36 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 the financial 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.
- 37 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.
- 38 EFRAG performed an analysis of the sensitivity of the results to changes in the discount rate. This analysis indicated that:
- (a) the lease liability and right-of-use asset are sensitive to the discount rate used, but not to the point that the results above would be substantially different; and
 - (b) earnings before taxes are only modestly sensitive.
- 39 The economic study commissioned by EFRAG included a similar quantitative assessment prepared on a larger sample of [2,215] listed entities across a range of

industries. This assessment found similar effects to those described above. Based on their assumptions the quantitative impact of applying IFRS 16 would be to:

- (a) create a total lease liability of [576] billion euro, representing [8%] of total debt or [15%] excluding the financial industry;
- (b) create total right-of-use assets of [528-551] billion euro, representing [14%-15%] of the total net book value (NBV) of property, plant and equipment;
- (c) increase the overall EBITDA impact on current leases with around [10%]; and
- (d) increase leverage ratios slightly (i.e. the Debt/Equity ratio would increase from [0.8 to 1] and Debt/Asset ratio would increase from [28%-32%]).

Impact of financial statement changes on behaviour of users

- 40 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 affected by the scale of an entity's lease commitments. However, the observed correlation between credit spreads and lease commitments is weaker than the correlation between credit spreads and financial debt. Some studies conclude that this indicates that users like banks consider operating leases differently from debt⁹. Others argue that this proves that current information on operating leases is insufficient and capitalisation would improve the investors' decisions¹⁰.
- 41 The economic study commissioned by EFRAG has examined the correlation between bonds yields and operating lease obligations (currently carried off-balance sheet) on a sample of [302] companies across [14] European Union countries representing a total of [912] associated bonds.
- 42 The study identified that, despite the current off-balance sheet treatment of operating lease obligations for accounting purposes, market participants seem to capture this type of commitment and treat it as a liability in their current decision-making. The liability associated with a fully capitalised operating lease is an important variable in determining bond yields, and the magnitude of this impact is statistically equivalent to the magnitude of the impact of debt liability.
- 43 In its outreaches with users¹¹, EFRAG has become aware that a clear majority of users (including credit rating agencies) already adjust reported figures to reflect operating leases. For example, one agency indicates that their approach is to capitalise operating leases with the aim of bringing companies' ratios closer to the underlying economics and consider 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.
- 44 Users (including lenders) have repeatedly supported capitalisation of leases. A 2013 survey of 288 global users¹² 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

⁹ Source: Altamuro, Johnston, Pandit and Zhang (2012), Operating leases and credit assessment.

¹⁰ Source: Cotton, Schneider and McCarthy (2013), Capitalisation of operating leases and credit ratings.

¹¹ Source: 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](#)

¹² Source: CFA Institute (2013), *Lease accounting survey report*.

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. In its public consultations and outreaches, EFRAG has received only limited feedback on how IFRS 16 will affect entities' cost of capital or access to finance. A majority of respondents that provided feedback assessed that it was unlikely that IFRS 16 would significantly alter their cost of capital because IFRS 16 does not change an entity's business operations, risks or creditworthiness.

- 45 The economic study commissioned by EFRAG similarly assessed that credit conditions for lessees and lease pricing are not expected to change materially (see the following section *Effect of IFRS 16 on the Leasing Industry*).
- 46 In its letter to EFRAG, the European Central Bank similarly considered that it did '*not expect major impacts of IFRS 16 on the credit conditions for lessees since current evidence seems to suggest that the effects of any off-balance sheet financing are already duly taken into account by financial analysts and creditors. However a certain effect on the interest rate charged for credit cannot be excluded, subject to the magnitude of the adjustments that are currently made by analysts to adjust for off-balance sheet leases*'.
- 47 Based on the above, EFRAG has concluded that there is no evidence that IFRS 16 would materially alter the way users will assess the credit conditions or cost of capital for lessees as they are already taking into account the effect of off-balance sheet financing in making their decisions.

Impact of financial statement changes on behaviour of lessees

- 48 EFRAG's assessment considered two broad ways in which lessees might change future economic behaviour in response to the accounting adjustments brought about by IFRS 16:
- (a) reconsider the residual advantage of operating leases against other forms of finance, resulting in some switching to other forms of finance; and
 - (b) seek to maintain off-balance sheet presentation by changing the lease term or the form of payment (i.e. move to shorter leases or variable payments).

Switching to other forms of finance

- 49 The use of leases is widespread in Europe. In 2013¹³, 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. Entities operating in these sectors employed approximately 2 million employees.
- 50 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 a primary reason for leasing was IAS 17's off-balance sheet accounting treatment of operating leases.
- 51 Entities may also consider the additional ongoing costs arising from the change in lease accounting in deciding whether to lease or to (borrow and) buy assets. The economic study commissioned by EFRAG attempted to estimate the possible scale of a reduction in demand for leasing. The approach taken involved first estimating the additional compliance costs resulting from IFRS 16. Second, those costs were assumed to be fully considered to be part of the cost of operating leases (which is a key assumption). This part of the study indicated that the implied cost of financing through operating leases could increase in the range of [4-4.5bps] compared to today. The survey responses obtained in the study suggested that a small but not

¹³ Source: Eurostat.

insignificant proportion of lessees could be sensitive to such price changes: around [6%] of lessees interviewed indicated that they could switch to an alternative funding option as a consequence of the increased costs triggered by IFRS 16. A [6%] reduction in global leasing by companies listed in the EU's regulated markets is equivalent to a decline of around [3%] in overall leasing volumes in the EU.

- 52 EFRAG has identified very few previous studies or other material to provide other sources of evidence on expected changes in lessees' behaviour. In a 2013 global survey of CFA Institute members with an interest in financial statement analysis¹⁴, over 60% expressed the view that entities would continue to engage in leasing transactions regardless of any requirement to capitalise operating leases. Accordingly, this strand of evidence is consistent the findings of the economic study commissioned by EFRAG in that any change in the volume of leasing activity is expected to be modest.
- 53 EFRAG also notes that there are a number of reasons why entities would continue to use leasing as one of their sources of finance. 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 reduce exposure 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.
- 54 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.

Changing the lease term or the form of payment

- 55 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 request shorter lease terms and additional extension and/or termination options. Another possibility is that lessees will want to replace some 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). In this case:
- (a) EFRAG considers that a pricing premium sought by lessors could act as counterweight to such a move. This is because shortening the length of lease contracts exposes lessors to a higher residual value risk and a higher risk of idle assets. It is therefore to be expected that lessors would require compensation for the additional risks in the form of higher lease payments; and
 - (b) lessees may be exposed to a risk of non-renewal of their leased assets to a greater extent because a lease is only classified as short-term if it does not contain a renewal option. The risk of non-renewal arises because the lessor will have the potential to re-lease the assets to others, or the desired assets may not be available given demand from other parties.
- 56 The economic study commissioned by EFRAG attempted to estimate the possible scale of this change in behaviour. The study obtained input from lessees on the incremental price they would be prepared to pay to change the terms of their leases to short-term or variable payment leases. Similarly, the study obtained input from lessors as to the additional price they would require to accept such changes. The

¹⁴ Source: *Lease accounting survey report* CFA Institute

study then estimated the number of lessees that would be able to find a willing lessor to accept the revised contractual terms at a price that would be mutually acceptable.

- 57 The evidence obtained in the study is that a small but non-negligible proportion of lessees could be willing to switch to short-term or variable payment types of leases despite a higher cost associated with these types of leases. The indicative results of the modelling exercise are that some [2–3%] of plant and equipment lessees, and some [10–12%] of property lessees, would be motivated to consider switching to shorter-term leases or leases incorporating variable payment structures and could find a willing lessor. The increase in financing costs associated with these revised contractual terms was however not expected to be large [2.2–5] million euro based on the reviewed sample.

Impact of IFRS 16 on the leasing industry

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

- 58 EFRAG's assessment of the potential impact of IFRS 16 in the leasing industry in Europe was informed by the economic study commissioned by EFRAG. This study considered the extent to which IFRS 16 is expected to lead to changes in behaviours of lessees and, specifically, changes in the demand for leases.
- 59 At its January 2016 meeting, the EFRAG Board also received presentations from Leaseurope and other investors in the leasing industry. EFRAG also considered this input when completing its assessment of the impact of IFRS 16 on the leasing industry.
- 60 Some leasing associations (essentially representatives of lessors of equipment and vehicles) have expressed concerns that IFRS 16 could have a negative impact on their business by introducing unnecessary changes and complexity in reporting requirements of lessees and potentially leading to a reduction in the use of leasing.
- 61 They highlighted that it was important to ensure that IFRS 16 does not interfere with the ability of European businesses to invest (using leasing in particular) as research had showed that leasing is important for financing assets with high residual value (something banks are more reluctant to do).
- 62 The economic study commissioned by EFRAG indicates that IFRS 16 may have a negative impact on the leasing industry, but that the impact should be modest and certainly not a threat to the continued viability of the industry. As noted in paragraph 51, the study estimated a reduction in the overall volume leasing in the EU could in the order of [5] billion euro, representing a [3%] drop in volume.
- 63 The study also considered whether this fall in demand could have knock-on effects on the availability, or more likely the pricing, of leasing to other market participants. This study considered:
- (a) potential changes in demand for leasing; and
 - (b) how the leasing industry might respond to a change in demand.
- 64 Lessors and lessor organisations that provided input to the study were asked how they would respond if faced with a small reduction in leasing demand of the order noted above. These respondents indicated that a mix of strategic responses is likely. The most common responses (which are not mutually exclusive) cited by lessors are that they would consider:
- (a) seeking small upwards price adjustments for all customers;
 - (b) making a mix of small up and down adjustments for particular segments of the market; and
 - (c) reducing overheads.
- 65 EFRAG notes that a very large proportion of EU-based lessors (by value) are subsidiaries of banks. The economic study commissioned by EFRAG indicated that approximately [90%] of new leases written in 2015 were written by bank-owned lessors. Accordingly, EFRAG anticipates that a substantial part of any switch between financing assets with leasing or with borrowings would represent a transfer of activity within different parts of the banking sector.
- 66 The implementation of IFRS 16 could also have an effect on innovation in leasing (i.e. how leases are structured going forward). 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

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

transactions, even to the extent that entities gain access to the benefits that can be provided by assets through a service contract rather than a lease (see also paragraphs 56-57 above). The study suggested that this possibility, together with the potential price adjustments on the supply side, might influence the ongoing trends in the leasing industry.

- 67 Overall EFRAG considers that IFRS 16 is likely to have some negative effect on the leasing industry but that this effect should be modest in scale and would not represent a threat to the overall viability of the industry. Lessors may seek to respond to any changes in demand in various ways.

Impact of IFRS 16 on SMEs

- 68 In its request for advice on the endorsement of IFRS 16, the European Commission requested EFRAG to 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.
- 69 EFRAG has approached its assessment from three perspectives:
- (a) the extent to which listed and unlisted SMEs are likely to apply IFRS 16;
 - (b) whether IFRS 16 is expected to be proportionate to those SMEs that apply IFRS; and
 - (c) whether the SME sector as a whole would be adversely affected by potential changes in the pricing and availability of leases.

Assessing the extent to which SMEs are likely to apply IFRS 16

- 70 No reliable and comprehensive data are available on the number of SMEs applying IFRS for their consolidated or individual annual financial statements as a result of Member States' options or because of a requirement from a non-regulated stock exchange (multilateral trading facilities).
- 71 EFRAG reached out to Member States of the European Union and the European Economic Area (EEA) through National Standard Setters and the Accounting Regulatory Committee to seek information. Information has been obtained for 25 of the 28 EU countries and for 1 of the 3 EEA countries.
- 72 EFRAG also reached out to a number of 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.
- 73 In summary, based the feedback received, EFRAG has identified that:
- (a) although Member State options have been applied in a variety of ways, only one Member State (Cyprus) requires all entities to apply IFRS. However, accounting and business organisations in that country have indicated to EFRAG that they do not expect IFRS 16 have material effect on Cypriot SMEs (considering their limited use of leases);
 - (b) overall the number of SMEs likely to apply IFRS 16 and the number of SMEs using IFRS, for their individual and/or consolidated financial statements, is expected to be very limited throughout the European Union and not to exceed 1% of total SMEs in most of the EU and EEA countries for which data is available. With the exception of Cyprus, unlisted SMEs that apply IFRS have elected to do so in accordance with the options available to them in the respective Member State's implementation of IAS Regulation;
 - (c) SMEs lease a wide range of asset types including premises, vehicles, plant and machinery, information technology, and office equipment. Some metrics indicate that SMEs are proportionately more reliant on leasing than larger businesses, while other metrics do not (see paragraphs 89-98 below); and
 - (d) SMEs generally enter into leases that are straightforward and do not include complex terms, although exceptions may exist in specific industries.
- 74 Although only a very small percentage of the 23 million or so SMEs in the EU and EEA would apply IFRS 16, the absolute number of SMEs that would apply the Standard is potentially large. EFRAG has therefore assessed whether the effects of IFRS 16 will be disproportionate for those SMEs that apply IFRS.
- 75 Lastly, some respondents to EFRAG's Preliminary Consultation Document indicated that, although they agreed that a clear majority of SMEs in Europe are not expected

to apply IFRS 16, there was, in their view, a risk of 'trickle down' of the principles contained in the new guidance into local GAAP and local tax rules. They observed that once new international rules are in place, there is always a good case to argue that national standards should change to achieve consistency. This would particularly affect SMEs and in their views IFRS 16 principles were seen as an unnecessary burden for un-listed SMEs which are less exposed to international benchmarking and global financing.

- 76 EFRAG acknowledges that additional effects may arise based on decisions made by Member States to introduce changes to their local accounting or tax legislation. However, EFRAG did not consider these in its assessment because they are of the exclusive competence of Member States.
- 77 EFRAG is not in a position to assess the likelihood of the changes nor their possible extent. EFRAG considers that Member States and National Standards Setters should consider whether additional impact assessments should be conducted, at national level, before or after the implementation of IFRS 16.

Assessing whether IFRS 16 is proportionate to SMEs

- 78 EFRAG first observes that there is a wide range of determinants for voluntary adoption of IFRS and this assessment, which is limited to the effects of IFRS 16 does not purport to consider all costs and benefits of adopting IFRS by unlisted SMEs.
- 79 Instead EFRAG assessed whether IFRS 16 will be proportionate to those SMEs that apply IFRS. To do so, EFRAG considered whether:
- (a) the administrative burden will be proportionally greater for SMEs; considering in particular the types of lease agreements typically entered into;
 - (b) the accounting impact will be proportionally greater for SMEs; and
 - (c) the economic/business impact will be proportionally greater for SMEs – for instance, whether the cost of capital for SMEs will increase proportionally more or less than for non-SMEs.

Whether the administrative burden will be proportionally greater for SMEs

- 80 In order to assess whether IFRS 16 is proportionate to SMEs, EFRAG first considered which factors are likely to create a bigger administration burden when applying IFRS 16 and then assessed whether these factors are likely to be more prevalent for SMEs.
- 81 Compared to IAS 17 *Leases*, IFRS 16 reduces the administrative burden somewhat by removing the need to classify leases between operating and finance leases. In some cases, this classification required significant time and judgement. Entities were also required to provide disclosures on operating leases, which required the collection of relevant information.
- 82 On the other hand, IFRS 16 adds complexity for the treatment of leases previously treated as operating because it requires an entity to:
- (a) capture and process more information on leases needed to comply with lessee accounting requirements;
 - (b) assess the rate implicit in the lease, although the lessee can fall back to its incremental borrowing rate if the implicit rate cannot be readily determined;
 - (c) assess the lease term - which can be more or less complex depending on the existence of options to extend or terminate; and
 - (d) reassess lease liabilities and assets when payments vary depending on indexes or rates.

- 83 However, EFRAG observed that IFRS 16 does not introduce a new accounting model but, instead, requires that all leases are accounted for similarly to finance leases under IAS 17. In most cases, this will result in lease assets being amortised on a straight-line basis over the lease term (like most tangible and intangible assets); and lease liabilities being carried at amortised cost, like financial liabilities. These measurements bases are generally well understood by entities (including SMEs) that already report under IFRS. However, EFRAG also notes that not all SMEs that enter into operating leases and report under IFRS will have experience of finance lease accounting.
- 84 EFRAG observed that IFRS 16 contains a number of simplifications aimed at reducing the application costs on an on-going basis namely:
- (a) the short-term exemption;
 - (b) the exemption for leases of low-value assets; and
 - (c) the option to allocate all the contract payments to the lease component.
- 85 None of these exemptions are specifically aimed at SMEs. However, EFRAG notes that simplifications are generally likely to be more beneficial to entities with smaller accounting departments and/or less specialised accounting skills.
- 86 In EFRAG's view, the factors likely to have the greatest impact on the administrative burden of SMEs are:
- (a) the volume of operating lease transactions an entity has entered into and the frequency of changes to terms and conditions; and
 - (b) the complexity of the lease agreements, such as the inclusion of non-standard terms and conditions such as options to extend or terminate; variable payments based on indexes or rates or the inclusion of significant service components.
- 87 No comprehensive data are available on the types of leases and nature of assets leased by these entities. However, organisations representing SMEs have indicated to EFRAG that, in their experience:
- (a) SMEs generally enter into leases that are straightforward and include standard lease terms, although exceptions may exist in specific industries. Complexity was expected to arise essentially from the level of judgement necessary to determine the lease term and the rate to discount future cash flows and the position at transition; and
 - (b) SMEs use leases to finance a wide range of asset types including premises, vehicles, plant and machinery, information, technology and communication as well as office equipment. Service components, when included, are quite often only ancillary.
- 88 EFRAG notes that this feedback is of a general nature and that some SMEs will undoubtedly enter into more complex leasing arrangements. The feedback does however seem broadly consistent with a report in 2015 on the use of leasing among European SMEs¹⁵ which identified the three most common types of assets leased by SMEs to be machinery and industrial equipment; passenger cars and light commercial vehicles; and information, technology and communication as well as office equipment. These categories accounted for about 65% of the total. Assets such as office equipment may qualify for the low value asset exemption with the possible exception of office equipment.

¹⁵ Source: The use of leasing among European SME – A report by Oxford Economics.

Assessing whether the accounting impact will be proportionally greater for SMEs

- 89 EFRAG has attempted to analyse whether the accounting adjustment required to be made by SMEs applying IFRS 16 would be greater or lesser in comparison to overall population of entities listed on the EU's regulated markets. EFRAG was not able to obtain data on the full current population of entities applying IFRS Standards in the EU for the purpose of this analysis. Instead, EFRAG performed an accounting impact simulation on a sample of SMEs applying IFRS based on the information available in a commercial database.
- 90 The sample included 487 SMEs from twenty countries that are either unlisted or listed on unregulated markets in an EU Member State, and used data drawn from 2014 financial statements. There was no distinction between those preparing consolidated financial statements and those preparing individual financial statements.
- 91 It has to be noted that the representativeness of such a sample is necessarily limited by the fact that the database covers only a very small proportion of total SMEs that are not listed on a regulated market. However, EFRAG observes that this selection approach is consistent with the one used by the European Commission for its evaluation of the IAS Regulation.
- 92 The results of the quantitative analysis, which were included in EFRAG's Preliminary Consultation Document, showed that:
- (a) the increase in lease liabilities of sampled entities amounted to 817.7 million euro, representing 12.4% of total debt. However, the sample includes 158 entities for which the net debt is zero. When these companies are excluded, the ratio changes to 9.8%;
 - (b) the right-of-use asset amounted 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 accounted for approximately 0.3% of total shareholders' equity.
- 93 Based on the above, EFRAG has concluded that:
- (a) the increase in lease liabilities and right-of-use assets upon transition to IFRS 16 may have a material, but not overwhelming, effect on the financial statements of entities included in the sample;
 - (b) the estimated accounting impacts based on the samples of large listed entities and listed and unlisted SMEs are not dissimilar; and
 - (c) the current practice by some users of adjusting the liabilities of entities using operating leases by applying a factor of 8 to operating lease cash flows may overestimate the lease liability. This seems consistent with the findings of the IASB Effects Analysis.
- 94 To obtain further insight into SMEs' use of leasing, EFRAG expanded its quantitative analysis with a focus on SMEs that use IFRS to meet reporting requirements of unregulated markets.
- 95 This second sample included 186 of such entities (most of which are listed on the London AIM stock exchange) and showed a particularly high ratio between simulated lease liability and debt. This analysis showed an increase in reported indebtedness of 39% versus the average 16% of the large entities sample excluding financial industry entities. However, the reason for this higher ratio was that the sample of listed SMEs included a higher proportion of entities reporting zero debt.
- 96 To understand better if these entities are particularly dependent on the use of leases, EFRAG calculated an additional ratio of net rental expense to total selling, general and administration expenses. The relevant data was extracted from the database with the year 2014 as a reference.

- 97 The additional ratio for the same 186 entities is equal to 7%. However, the ratio is particularly high for some of them – the median is 4.8%. EFRAG calculated the same ratio for the sample of large listed entities examined in the first sample. When entities from the financial industry are excluded, the ratio for the sample is 12.1% in average, with a median of 11.7%.
- 98 In its outreach with organisations representing SMEs, EFRAG heard that the impact on reported profit or loss resulting from IFRS 16's lease expense front-loading effect could be proportionally higher for SMEs. This is because proportionately more SMEs may have only one or a few dominant leases. The front-loading effect over the period of the lease from the renewal of these predominant leases would be less likely to be offset compared to larger entities with a more balanced portfolio of lease contracts.

Assessing whether the SME sector has a whole would be adversely affected by changes in the pricing and availability of leases

- 99 Although most SMEs do not apply IFRS, if IFRS 16 leads to a reduction in the demand for leases from some listed entities, there is a possibility that lessors would seek to recoup lost revenues and profits from other market participants. This could particularly affect SMEs (included unquoted ones) considering their high reliance on leases and the fact that, when compared to larger entities, other sources of finance might be less readily available.
- 100 According to a European Commission survey on access to finance in 2015, SMEs in the EU identify bank credit lines or overdraft and bank loans as the most relevant sources of external financing, whilst leasing and hire purchase are considered to be third most relevant¹⁶. In particular, 49% of surveyed SMEs mentioned leasing as relevant for their financing in 2015, while credit lines or overdrafts and bank loans are mentioned by more than half of the respondents.
- 101 Any change in the cost of leasing for SMEs would be proportional to the extent to which these firms rely on operating leases for funding, and the pricing and availability of substitute sources of funding. However, given that the economic study commissioned by EFRAG suggests that the increase in the cost of operating leases would most likely be a few basis points at worst. The impact, if any, on the overall cost of leasing should therefore be negligible.

Conclusion on impact on SMEs

- 102 Based on the various studies and analyses described above, EFRAG assesses that:
- (a) only a very small proportion of SMEs in Europe would apply IFRS 16 if it was endorsed;
 - (b) for SMEs that would apply IFRS 16, there is no clear indication that the resulting administrative burden would be disproportionate. EFRAG does however acknowledge that SMEs generally experience greater challenges than larger entities in implementing any significant accounting change; and
 - (c) EFRAG has not identified evidence that SMEs would be materially adversely affected by changes in the pricing and availability of leases resulting from IFRS 16.
- 103 Based on the above, EFRAG has not identified any evidence that IFRS 16 would be disproportionate to the SME sector in Europe.

¹⁶ Source: European Commission (2015), SME's Access to Finance Survey 2015.

Is IFRS 16 likely to endanger financial stability in Europe?

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

- 104 As an observer on the EFRAG Board, the European Central Bank (ECB) provided a qualitative assessment as an input into EFRAG's endorsement advice on the effects of IFRS 16 on financial stability.
- 105 In its letter dated 12 December 2016¹⁷ the ECB assessed that IFRS 16:
- (a) constitutes prudent accounting and may enhance market confidence by better reflecting the actual leverage of lessees and by reducing incentives for arranging lease contracts in such a way as to achieve a particular accounting outcome by means of presenting all leases on the face of the balance sheet;
 - (b) promotes a forward-looking recognition of risks by providing detailed guidance on the reassessment of lease liabilities with early recognition of changes in the debt of the reporting entity which in turn contribute to safeguarding financial stability as it provides a better reflection of the economic reality;
 - (c) does not significantly change the impact on credit conditions of lessees (such as debt covenants, interest rates, etc.) which arise from recognising more debt on the balance sheet, as entities are likely to enter into leasing arrangements for a number of reasons other than off-balance sheet financing (which are normally already taken into account by financial analysts and creditors); and
 - (d) provides relevant and reliable accounting information as the options provided under IFRS 16 are not expected to significantly hinder the comparability of financial information.
- 106 Based on the above, the ECB concluded that it had not identified conclusive evidence to indicate that IFRS 16 would pose a significant risk to financial stability in Europe.
- 107 The ECB however highlighted that its conclusions had been reached on the basis of a qualitative assessment of the expected effects of IFRS 16 only; and therefore it was important to monitor the effects of IFRS 16 on financial stability after IFRS 16 has become effective in January 2019.
- 108 EFRAG has also sought the views of its constituents on the expected effects of IFRS 16 on financial stability through its public consultations and outreaches. EFRAG has received limited feedback as most respondents considered that they were not in a position to address the issue. However, the few respondents that commented, provided feedback that is generally consistent with the ECB analysis and in particular, most of these respondents:
- (a) were of the view that bringing all leases on balance sheet will provide both preparers and users of financial statements with more transparent and meaningful information about the gearing of entities applying IFRS, which in turn should bring potential issues to light at an earlier stage; and
 - (b) observed that IFRS 16 did not affect cash outflows but only brought more visibility to financial commitments that were only disclosed in the notes to the consolidated financial statements.
- 109 A few respondents (representing mainly financial institutions) however indicated that the effects of IFRS 16 on financial stability should also be assessed in consideration of its potential effects on banks' prudential ratios. These respondents expressed more specifically concerns about the lack of clarity on the prudential treatment of right-of-use assets for capital regulatory requirements of banks as lessees and

¹⁷ Source: European Central Bank *Qualitative assessment of IFRS 16 Leases from a financial stability perspective*. Available [here](#)

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

whether such assets would be considered as tangible or intangible. This would affect the determination of the risk-weighted assets and, with it, leverage and solvency ratios used for calculation of the regulatory capital.

- 110 As an observer on the EFRAG Board, the European Banking Authority (EBA) provided an assessment as an input into EFRAG's endorsement advice of the impact of IFRS 16, in particular from a prudential supervisory perspective. In its letter dated 11 January 2017¹⁸, the EBA indicated that they have conducted:
- (a) a qualitative analysis of the interaction of IFRS 16 with the existing prudential requirements being the nature of the right-of-use asset and the prudential treatment of these assets for capital, leverage and liquidity purposes; and
 - (b) a quantitative analysis of the impact of IFRS 16 on a sample of 65 banks across 19 countries in the European Economic Area (each country being represented by at least three banks with different sizes, business model and risk profile).
- 111 The EBA concluded that its analysis suggested that overall IFRS 16 would not raise significant challenges related to bank regulation and the impact of IFRS 16 on own funds and leverage ratios of banks was estimated to be of rather limited significance.
- 112 The EBA acknowledged that its analysis included a number of limitations and was conducted on the basis of the available data at the time the analysis was performed. The actual impact of IFRS 16 could differ across different banks and jurisdictions when IFRS 16 is initially applied. The impact will depend mainly on the magnitude of the lease obligations that a bank holds which will need to be recognised when IFRS 16 is initially applied.
- 113 Lastly, the EBA indicated that it would continue analysing the interactions of IFRS 16 with the prudential regulatory framework taking into consideration any developments at the international level, namely at the Basel Committee of Banking Supervision.

¹⁸ Source: European Banking Authority *The EBA's view on the adoption of International Financial Reporting Standard 16 Leases (IFRS 16)*; Available [here](#).

Potential effects on competitiveness

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

- 114 In February 2016, the FASB issued Accounting Standards Update *Leases* (Topic 842) that introduces new accounting requirements for entities reporting leases under US GAAP.
- 115 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 US GAAP 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.
- 116 However, IFRS 16 and US GAAP 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

- 117 In US GAAP, 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.
- 118 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.
- 119 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 higher costs at the beginning of the term of new leases than under US GAAP.
- 120 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).
- 121 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.

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

- 122 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 US GAAP 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

- 123 Neither IFRS nor US GAAP have a definition of 'debt' and neither the IASB nor the FASB 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.
- 124 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 preparer's view of whether lease liabilities are financial or non-financial in nature.
- 125 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 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.

Ongoing application costs

- 126 EFRAG notes that there is disagreement about whether US GAAP or IFRS 16 would be more costly to apply.
- 127 In their response to EFRAG's Preliminary Consultation Document, a few constituents indicated that they 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. These constituents also considered that the benefit of the additional exemptions existing under IFRS 16 (for leases of low value items) would be outweighed by the additional disclosures required about payments made under such leases.

- 128 Conversely, some other respondents indicated that the dual model in US GAAP would 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; and
 - (b) US GAAP does not include an exemption for leases of items of low value.
- 129 EFRAG also observes that, 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 arithmetic 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.
- 130 Lastly, EFRAG observes that US GAAP 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

- 131 The impact of applying IFRS 16 or US GAAP on financial position and performance is mixed. Overall 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 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.

Costs and benefits of applying IFRS 16

Introduction

- 132 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.
- 133 The approach that EFRAG has taken 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

- 134 EFRAG has carried out an assessment of the costs for preparers resulting from the application of IFRS 16.

Cost for lessors

- 135 IFRS 16 carries forward most of the existing requirements for lessor accounting. It is therefore expected that any incremental costs for lessors will be low because the changes in IFRS 16 to lessor accounting have a relatively minor impact.
- 136 However, some lessors and lessor organisations have indicated to EFRAG that costs may be incurred by lessors indirectly, as a consequence of their customers (lessees) requesting more information about their leases in order to implement IFRS 16. This could include information about interest rates implicit in leases and/or the stand-alone selling prices of lease and non-lease components. Although no quantitative assessment was provided, these constituents indicated that one-off costs could be significant as some lessors may not have the systems in place to gather and share this information, and new IT solutions may then be needed. The extent of these costs will depend to some extent on whether lessees select a full or modified retrospective transition approach on implementing IFRS 16 because this selection will affect the amount of time that lessors have to provide the information requested.

Cost for lessees

- 137 The IASB has sought to reduce the cost of transition to IFRS 16 for preparers by providing options, exemptions and practical expedients. Some of these are accounting policy choices, some apply by class of underlying asset and some can be elected on a lease-by-lease basis. This results in multiple possible ways to transition to IFRS 16. The choice of the transition methods will have an impact on the cost of implementation.
- 138 This range of options makes it more 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 will provide significant relief upon transition for those entities that elect not 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.
- 139 Feedback received in outreaches with preparers indicated that most preparers have not yet decided which transition method they will use. However, a majority of respondents have indicated to EFRAG that, to mitigate costs, they would consider using the recognition exemption for leases of assets of low value and, to a lesser extent, the exemption for short-term leases. Leases of office equipment, small IT and printers would typically fall into the low-value asset exception. 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 for lessees

Understanding IFRS 16 and selecting accounting policy choices

- 140 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. Having obtained this understanding, entities then need to make decisions about their specific approach to implementing IFRS 16, such as which practical expedients to use. These accounting policy choices will need to be documented and considered throughout the processes associated with implementing and applying IFRS 16.

Systems and controls

- 141 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 status 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

- 142 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.
- 143 Entities that have a decentralised lease administration system, for example a system in which leases are administered at individual business unit- or geographic location-level, may face additional costs if they decide to centralise their lease administrations. Similarly, where existing databases (whether centralised or decentralised) have limited capacity and functionality, costs may be incurred to make the necessary enhancements.
- 144 If existing systems do not provide the necessary functionality, 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.
- 145 Some constituents have emphasised that no 'off-the-shelf' IT package providing all the functionality required to implement IFRS 16 is currently available. Such a package would need to interface with their existing software modules which differs from country to country and allow, in particular, some form of linkage between asset and liability accounting.

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

- 146 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.
- 147 Entities that already have comprehensive 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.

SET UP PROCESSES AND CONTROLS

- 148 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. Additional audit fees and control cost (including internal control) may also be incurred.
- 149 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.
- 150 In its assessment, EFRAG notes the potential for changes to many processes and has considered the major processes for:
- (a) identifying if a contract is, or contains, a lease (this is already required under existing standards);
 - (b) 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.

PROCESS TO IDENTIFY IF A CONTRACT IS, OR CONTAINS, A LEASE.

- 151 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.
- 152 As mentioned in paragraph 139 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.

PROCESS TO SEPARATE LEASE AND NON-LEASE COMPONENTS.

- 153 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.
- 154 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.

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

PROCESS TO COLLECT THE ADDITIONAL INFORMATION NEEDED TO FIRST APPLY THE REQUIREMENTS IN IFRS 16.

- 155 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.
- 156 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).
- 157 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. Lessees may request information on these discount rates from lessors. When these rates are not readily available, lessees have to take into account the initial investment, the residual and the lease payments in order to determine the appropriate discount rate. 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

- 158 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.
- 159 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

- 160 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.
- 161 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

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

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.

- 162 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 for lessees

- 163 The main driver of ongoing costs for lessees is expected to arise from the monitoring of new and existing capitalised operating leases and any IT maintenance costs. Such costs are likely to be higher for leases that have more frequent changes as changes would trigger the need to reassess and re-measure the lease liability and right-of-use assets. EFRAG understands that, for some types of lease (e.g. some car leases), such changes can occur frequently and affect not only the duration of a lease but also the rental, maintenance fee, service and risk components. Such modifications may differ from one contract to another.
- 164 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.
- 165 EFRAG assesses that the data required to implement IFRS 16 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;
 - (b) carrying the right-of-use assets at cost less depreciation and impairment;
 - (c) remeasuring the lease liability under certain circumstances;
 - (d) consolidating intra-group leases; and
 - (e) providing the additional disclosures required by IFRS 16.
- 166 As mentioned in paragraph 139, EFRAG expects that the exemptions for short-term leases and leases of low-value assets will reduce costs in the above areas.

DISCOUNTING LEASE PAYMENT OBLIGATIONS

- 167 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.
- 168 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, initial direct costs incurred by the lessor and the residual value. 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.
- 169 EFRAG however observes that when the interest rate implicit in a lease is not readily determinable, IFRS 16 requires the use of the lessee's incremental borrowing rate, thereby reducing complexity and cost.

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

- 170 Ongoing costs 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

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

and by the frequency of remeasurements of the right-of-use assets and lease liabilities.

REMEASURING THE LEASE LIABILITY

- 171 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; and
 - (b) lease payments that are linked to an index or rate (e.g. inflation).
- 172 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 in most cases. This is because the threshold for reassessment is relatively high and 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. EFRAG expects that changes in relevant factors resulting in the lessee having, or no longer having, a significant economic incentive to exercise an option should be relatively infrequent.
- 173 However constituents in some specific industries (retail and car leasing) have indicated to EFRAG that the requirements might be complex, and therefore costly, to apply due to features such as large volumes of leases with unique term clauses, long maximum possible lease term (including evergreen options) or the frequency of revisions to terms and conditions occurring over the lease term. These constituents were concerned that an entity would have to continuously assess and monitor relevant factors.
- 174 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 annual reporting date. The significance of the costs incurred will also most likely 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 INTRA-GROUP LEASES

- 175 EFRAG is aware of cases in which a group entity secures a head 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.
- 176 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

- 177 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.
- 178 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.

- 179 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

- 180 As explained above, EFRAG expects the main ongoing costs to arise from monitoring of new and existing capitalised operating leases and any IT maintenance costs.
- 181 In its assessment, EFRAG has 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.
- 182 As mentioned in paragraph 139, 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 useful cost reliefs for some lessees. However EFRAG also understands that short-term leases represent only small proportion of overall lease volume on Europe.
- 183 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 a significant effect on reported figures.
- 184 Outreaches with preparers have identified that a majority of lessees were considering using the recognition exemptions for leases of low-value assets in order to mitigate costs. However, respondents did not expect significant cost relief as a result of the relatively low penetration of such leases in terms of overall volume.
- 185 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.

Quantification of one off-costs and ongoing costs

- 186 EFRAG received very limited quantitative input on costs in the course of our outreaches and consultations with preparers: most participants or respondents indicated that they were still in the early stages of their implementation project and could not provide any form of estimate.
- 187 Application of accounting standards in general does not readily lend itself to precise quantification of implementation costs on an ex ante basis. This is because very little ex-ante data is available and expected costs vary significantly between entities on account of, the diversity in the number and type of operating leases and differences in the current IT systems and processes.
- 188 The economic study commissioned by EFRAG included structured interviews with a total of [246] European entities listed on regulated markets that disclose lease obligations, across [8] countries (out of an estimated total of approximately [2,300] such entities). Of the [246] entities interviewed, [77] were able to provide a cost quantification.
- 189 The figures presented below are derived from an extrapolation of the data gathered from these structured interviews. EFRAG notes however that these amounts should be taken only as very broad and indicative estimates, noting the inherent limitations mentioned above and the fact that most entities are still at a very early stage of their

implementation processes. Accordingly, the estimates obtained, and the basis of their extrapolation beyond the sampled entities, are subject to a high degree of uncertainty.

- 190 The economic study provided the following very broad and indicative estimates:
- (a) The main one-off costs for lessees are expected to relate to the analysis of existing contracts, the purchase of additional IT systems and potential process changes. These are estimated to aggregate to [176–202] million euro, based on an extrapolation of the cost estimates provided by the [77] responding entities to the [2,300] listed entities in the initial sample. The cost estimates provided ranged from [zero to 1.3] million euro, and the average cost per entity is estimated to be in the order of [80,000] euro.
 - (b) Cost estimates vary significantly across entities and this stems from the diversity in the number and type of operating leases and differences in the current IT systems and processes.
 - (c) Ongoing costs are expected to be generally much smaller than one-off costs. Subsequent to the first implementation, processes can be absorbed and some level of automation can be achieved. However, ongoing costs are likely to be higher for leases that have more frequent changes than for simple leases because of the need to reassess and re-measure the lease liability and right-of-use asset. Ongoing costs, extrapolated to the sample of [2,300] listed entities were estimated to be around [51-58] million euro (a cost per entity ranging from [0 to 200,000] euro with an average of [24,000] euro).
 - (d) Only a small fraction (about a quarter) of lessees did not expect to incur any additional ongoing costs due to IFRS 16.
 - (e) Implementation costs for lenders and lessors are expected to be much lower than costs to lessees. This reflects the fact that most lenders are already making adjustments for operating leases when evaluating a company's creditworthiness. One-off implementation costs were estimated to be on aggregate in the order of [6–9] million euro.

Conclusion – Costs for preparers

- 191 Overall, EFRAG's assessment is that lessees will incur one-off costs but these costs are generally rather modest in scale. Lessees will also incur ongoing compliance costs but these will be lower still. Costs will however vary considerably, depending in particular 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.
- 192 Costs may be mitigated slightly by the use of the various options and exemptions available in IFRS 16, but the penetration of short-term leases, leases of low value assets and variable payment leases is assessed to be low. Part of the cost may also be 'shifted' to lessors if lessees rely on lessors to provide some of the information needed to implement the requirements.

Costs for users

One-off costs

- 193 In outreaches and consultations, users have generally indicated to EFRAG that they expect to incur incremental one-off costs to understand the new requirements, modify their processes and analyses and educate their staff. Costs to update their data and re-establish comparable information about trends may also be incurred as preparers make use of the various transition options, exemptions and practical expedients in IFRS 16.

IFRS 16 Leases
EFRAG's Draft Letter to the European Commission
Appendix 3

194 Although no detailed quantification of cost was provided in response to EFRAG's consultations, most user respondents to the EFRAG questionnaire assessed that costs would be moderate (graded 2/3 on a scale of 1 (low) to 5 (high)).

Ongoing costs

195 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.

196 Consultations with users have confirmed that most users do not expect their ongoing costs to increase significantly. Although no detailed quantification of cost was provided, respondents generally that assessed incremental ongoing costs to be low (graded 1 on a scale of 1(low) to 5 (high)).

197 Users have generally indicated that IFRS 16 may reduce the need for adjustments to figures reported by lessees however they did not generally expect significant decreases in cost. This is because a majority of users has indicated that they expect to continue to make some levels of adjustments for instance to:

- (a) enable existing data series to continue;
- (b) take into account the impact of contingent rentals (which are excluded from the calculation); or
- (c) take into account the fact that IFRS 16 requires capitalisation based on contractual terms and therefore adjustments may be necessary for lessees with shorter/longer than average lease terms to allow comparisons

198 Lastly, a majority of respondents has also indicated that they do not expect to make adjustments for leases of low-value items or short term leases that are not recognised by lessees.

Conclusion – Costs for users

199 Overall EFRAG has assessed that IFRS 16 is not expected to increase significantly one-off and ongoing costs for users.

200 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 and reduce the need for adjustments which could result in a reduction of ongoing cost. However, EFRAG understands that users may continue to make adjustments for instance to make information comparable for entities with different lease residual maturities.

Benefits for users and preparers

201 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

202 Feedback from EFRAG's consultations and outreaches have indicated that a very large majority of users agreed with EFRAG's assessment that IFRS 16 would provide more useful and transparent information on lessees and a better starting point for their analysis. Only a few users have indicated to EFRAG that IFRS 16 would not result in improved information, generally as a result of a preference for a straight-line expense profile for operating leases over IFRS 16's front-loaded expense profile.

203 IFRS 16 provides a more accurate measure of lease liabilities when compared to the short-cut estimates developed by investors and analysts to overcome the lack of information provided by applying IAS 17. Users have indicated to EFRAG that this is

expected to allow them 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.

- 204 EFRAG also observes that 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.
- 205 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 to a certain extent by the options, exemptions and practical expedients (which is unlikely to occur as a majority of users indicated they do not expect to make any adjustments for these) available in IFRS 16, both upon transition and on an ongoing basis.

Benefits for preparers

- 206 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.
- 207 For certain entities with large portfolio of leases, the information required under IFRS 16 may result in a greater focus by management and by users on the effects of leasing activities. 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 to gain insights into how they manage their financial leverage.
- 208 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.
- 209 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. Conversely, as noted in the assessment of costs above, IFRS 16 may require the application of increased judgement in other areas (such as the identification of whether a contract contains a lease or the determination of lease term).
- 210 EFRAG expects that users will derive most of the direct benefits from the improvements in the external financial reporting of leases resulting from IFRS 16. EFRAG nonetheless assesses that preparers may also derive benefits as a result of improvements in the quality and/or availability of internal management information about the effects of leases resulting from the implementation of the Standard (particularly for entities with a high volume of operating leases that are currently administered in a decentralised basis). Such informational improvements may

facilitate better economic decision-making as a result of greater focus on the effects of leasing activities.

Conclusion on the costs and benefits of IFRS 16

- 211 EFRAG acknowledges that the distribution of costs and benefits may be uneven among stakeholders insofar as costs are largely expected to be incurred by entities preparing IFRS financial statements whereas benefits are shared by them, users of financial statements (including investors) and the wider economy.
- 212 However, EFRAG's overall assessment is that the benefits of IFRS 16 to users and (to a smaller extent) preparers, including greater transparency about an entity's financial leverage and capital employed, enhanced information about leasing activity, improved comparability between entities that lease assets and entities that borrow to buy assets, are likely to outweigh the costs.
- 213 Benefits may however be somewhat reduced by a number of recognition and measurement options, exemptions or practical expedients available, both upon transition and on an ongoing basis. Benefits may also be limited due to potential competition issues as some doubt the capacity of smaller lessors to provide information that lessees may expect from lessors. Furthermore, the information (such as residual values, investment amount, split between financial services part of the rent and internal interest rates) required to implement IFRS 16 may be commercially sensitive to the lessor and there may be a tension between the need to satisfy customers' needs versus sharing sensitive information.
- 214 However, EFRAG has assessed that IFRS 16 reaches 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.

Appendix 4: Summary of EFRAG's Outreach Activities

- 1 The table below provides an overview of outreach activities and consultations conducted by EFRAG since 2013.

<i>Activities performed by EFRAG, in isolation or jointly with European National Standard Setters</i>			
Date	Type of activity	Performed by	Constituents
June 2013	Outreach event in Brussels with users on the main aspects of the 2013 ED	EFRAG	13 participants
July 2013	Outreach event in Vilnius	The National Standard Setter of Lithuania, EFRAG and the IASB	26 participants
July-August 2013	Field-test on classification and measurement requirements	EFRAG, ANC, DRSC, FRC, OIC	40 respondents
February 2014	Limited survey on proposed simplifications	EFRAG, ANC, DRSC, FRC, OIC	44 respondents
June-August 2014	Additional public consultation for preparers and users on scope and preference between IASB/FASB approaches	EFRAG, ANC, DRSC, FRC, OIC	60 respondents
September 2014	Outreach event (roundtable) in Brussels on scope and preference between IASB/FASB approaches	EFRAG	34 participants
December 2015	Public survey on the expected effects of IFRS 16 on financial covenants in loan agreements	EFRAG, AAT, ANC, DRSC, OIC, FRC.	52 participants
June-October 2016	Outreach on Definition of a leases	EFRAG, ANC, FRC	59 participants
July 2016	Users Roundtable on Leases	EFRAG, EFFAS and BVFA/ABAF	25 participants
October 2016	Preliminary Consultation Document	EFRAG	33 responses
November 2016	Additional questionnaire to Users	EFRAG	25 responses
November 2016	Joint user event on Leases and Insurance Contracts	EFRAG/EFFAS/OIC/AIAF	50 participants