

## EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

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# **IFRS 16 Leases**

## **EFRAG's Final Endorsement Advice**

### **Review based on EFRAG's consultations**

#### **Objective**

- 1 The objectives of the session are to:
  - (a) consider the feedback received in response to EFRAG's Draft Letter to the European Commission Regarding the Endorsement of IFRS 16 *Leases* (hereafter the draft endorsement advice on IFRS 16 Leases); and
  - (b) approve a letter to the European Commission regarding the endorsement of IFRS 16 *Leases* (hereafter *the Final Endorsement Advice*).

#### **Background**

- 2 EFRAG conducted the consultation on its endorsement advice in two phases.
- 3 In October 2016, EFRAG published a Preliminary Consultation Document (PCD) regarding the endorsement of IFRS 16 and a questionnaire seeking the views of users and user organisations on a number of issues in relation to its assessment on costs and benefits and whether IFRS 16 is an improvement over IAS 17.
- 4 In February 2017 issued a Draft Endorsement Advice (DEA), including an assessment on European public good, taking account of:
  - (a) Comments from constituents in response to EFRAG's PCD and user questionnaire;
  - (b) Additional research undertaken in respect of the impact of IFRS 16 on SMEs;
  - (c) Findings from the economic study commissioned by EFRAG; and
  - (d) Expert advice from the European Central Bank and the European Banking Authority (EBA) in their areas of expertise.
- 5 In the DEA, EFRAG's overall initial assessment was that IFRS 16:
  - (a) Meets the qualitative characteristics of relevance, reliability, comparability and understandability, leads to prudent accounting, and it is not contrary to the true and fair view principle;
  - (b) Would improve financial reporting and would reach a cost-benefit trade-off that is acceptable. EFRAG has not identified that IFRS 16 would have major

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deleterious effects on the European economy, including financial stability and economic growth. Accordingly, EFRAG assessed that adopting IFRS 16 is conducive to the European public good.

- 6 Although the Invitation to Comment accompanying the DEA invited comments on any part on the DEA, the questions focused on components of the assessment of European public good (Appendix 3) which were not part of EFRAG's PCD.

### Overview of the DEA consultation

- 7 At the time of writing, EFRAG had received 29 responses. The table below provides a breakdown of respondents by types and countries. A full list of respondents is included in Appendix 1.

#### Profile of respondents to the DEA

Users and organisations of users	3	Denmark	1
Preparers and organisation of preparers	16	Europe	5
Leasing organisation	2	France	4
Standard setters and accounting organisations	6	Germany	14
Professional organisations	2	Italy	1
Regulators	0	UK	2
Consultants and accounting firms	0	International	2
	<b>Total</b>	<b>Total</b>	<b>29</b>

- 8 One respondent found the argument in Appendix 3 well motivated. That respondent referred to their comment letter on the Preliminary Consultation Document and made no further comments. The main feedback from other constituents is summarised below, under the following headings:

- (a) Potential effects on stakeholders' behaviours
- (b) Potential impact of IFRS 16 on the leasing industry
- (c) Potential impact of IFRS 16 on SMEs
- (d) Costs and benefits
- (e) Additional input into the quantification of implementation cost

- 9 All letters are accessible on EFRAG's website [here](#) (under 'endorsement consultation').

#### Potential effects on stakeholders' behaviours

- 10 27 respondents provided feedback on the potential impacts of IFRS 16 on the leasing industry. All but one agreed with EFRAG's assessments that (i) IFRS 16 is not expected to have any material effect on entities' access to and the pricing of leasing as a source of finance; and (ii) 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.
- 11 One respondent considered that EFRAG's assessment and the economic study commissioned by EFRAG under-estimated the economic impacts for lessors in particular regarding lease pricing. This respondent indicated that listed companies

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were already actively engaged in commercial renegotiations for alternatives to leasing or revisions to terms of leases to avoid recognition in the balance sheet. However, this respondent did not provide any alternative elements of quantification for such effects that would differ from the ones contained in the economic study commissioned by EFRAG.

### *Potential impact of IFRS 16 on the leasing industry*

- 12 23 respondents provided feedback on the potential impacts of IFRS 16 on the leasing industry.
- 13 The vast majority 21 agreed, with no further comments, with EFRAG's assessment 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.
- 14 Two associations of specialised finance companies disagreed with EFRAG's assessment. One of these respondents indicated that IFRS 16 will have a negative impact on the business model of institutions in Europe currently offering leases that include services by introducing an inappropriate distinction between leases and service contracts and an overly complex substantive right of substitution requirement. To resolve this situation this respondent reiterated its suggestion that, at a minimum, consideration should be given to 'relaxing' the application of the 'right of substitution'. The respondent considered that the guidance in IFRS 16 in this area is unduly restrictive and would result in most of the reasons why lessors would retain a right to replace assets being treated as non-substantive.
- 15 Conversely, another association of finance companies, while agreeing with EFRAG that IFRS 16 'does not represent a threat to the overall viability of the leasing industry', emphasised that certain issues, already acknowledged in the DEA should not be ignored:
  - (a) The requirement to separately account for lease and non-lease components could entail a commercial risk for lessors (identification of pricing components could result in lessees attempting to contract each one separately); and
  - (b) Lessors will incur cost to develop their systems in order to provide their customers with all the information on these components.

### *Potential impact of IFRS 16 on SMEs*

- 16 22 respondents provided feedback on the potential impacts of IFRS 16 on SMEs. 6 respondents did not provide input on the issue.
- 17 The clear majority of respondents that provided input 19 out of 22 agreed with (i) EFRAG's assessment that IFRS 16 is not expected to have any material adverse or disproportionate impact on the SME sector in Europe; (ii) the DEA's acknowledgement that SMEs generally experience greater challenges than larger entities in implementing any significant accounting change.
- 18 3 respondents disagreed with EFRAG's assessment. In their view IFRS 16 was not tailored for SMEs and its application would be disproportionately complex and costly for limited benefits and may result in some European SMEs being at a competitive disadvantage.
- 19 Two of these respondents assessed that, although a clear majority of SMEs in Europe were not currently required to apply IFRS 16, there was a risk of 'contagion' to areas outside its original intended scope (i.e. convergence of National GAAPs

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towards the principles in IFRS 16). One respondent noted that few, if any, National Standard Setters are considering changing National GAAP.

- 20 To address these concerns these respondents reiterated some of the suggestions made in response to the PCD:
- (a) Allow more time for SMEs to prepare for the changeover by rescheduling the application date for SMEs (as defined in the EU) to periods on or after 1 January 2023;
  - (b) Ask EFRAG to explicitly advise the European Commission that IFRS 16 'should not apply to SMEs and that Member States should not indirectly spread its application to local GAAP'.
- 21 Another respondent, while agreeing with EFRAG's overall assessment, reiterated the view that the principles in IFRS 16 were inadequate for individual financial statements and for non-listed entities, in particular SMEs.

### *Costs and benefits*

- 22 25 respondents agreed with EFRAG assessments that IFRS 16 would reach a cost-benefit trade-off that is acceptable.
- 23 2 respondents, representing association of finance companies, disagreed with EFRAG's assessment:
- (a) One respondent indicated costs of applying IFRS 16 would exceed the benefits for lessees and lessors;
  - (b) One respondent indicated that the cost-benefit trade off would not be acceptable if the standard was 'extended' to SMEs.
- 24 These respondents considered that entities will incur significant one-off costs (despite the available transition options and scope exceptions) for unclear benefits.
- 25 While overall agreeing with EFRAG's assessment one preparer indicated that benefits for users should not be overstated as comparability may be reduced by the level of judgement and the number of options in the standard.

### *Additional input into the quantification of implementation cost*

- 26 5 respondents provided quantitative indications of the implementation costs of IFRS 16:
- (a) One preparer in the telecommunications industry, with about 200,000 leases across 30 jurisdictions, estimated its implementation cost to be around 50 million euros (of which 10 million comprised of external costs, the remainder consisting of internal staff allocated to the project);
  - (b) Another preparer in the same industry reiterated its previous assessment the incremental one off and ongoing costs to be 'in a high single digit million euro';
  - (c) One preparer in the chemical industry estimated its one-off costs to range between 5 and 10 million euro, mainly comprised of IT and process changes;
  - (d) One preparer assessed that the ranges of amounts included in EFRAG's draft endorsement advice seemed too low and did not appear to be realistic, although this respondent did not provide any alternative assessment;
  - (e) One association of specialised finance companies indicated that, some of its members expected to incur, as lessees, external costs in the range of 300,000 euro (external consultant should be employed in order to gather the data of the existing contracts, create a database and develop a new IT tool). However internal staff would also need to be dedicated to the implementation of the standard with an overall implementation period ranging from 5 to 8 months.

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- 27 It has to be noted that the above feedback was provided by very large listed entities with multinational activities and a high volume of leases.
- 28 No quantitative assessment was provided for entities as lessor.

### **Other comments received**

- 29 A number of additional comments were provided by respondents in their comment letters. They are summarised below.

#### *Effective date of IFRS 16 and timing of the endorsement process*

- 30 3 respondents reiterated concerns previously expressed in response to the PCD consultation, about the timeliness of the endorsement process. They emphasised again that it was of the utmost importance that IFRS 16 is endorsed in a timely manner as:
- (a) some preparers are considering early adoption as of January 2018, so as to apply IFRS 15 and IFRS 16 at the same date and they would not be in a position to do so if IFRS 16 is not endorsed by the end of 2017; and
  - (b) the cost of endorsement will be significantly increased if the endorsement is delayed.

#### *Effects on regulatory capital requirements*

- 31 4 respondents reiterated previously raised concerns about the lack of clarity about the interaction of IFRS 16 with prudential regulation and the resulting uncertainty regarding impact on solvency, leverage and liquidity ratios of financial services entities.
- 32 These respondents commented that, as nothing has changed from a risk perspective, the accounting change introduced by IFRS 16 should not, by itself, impact the regulatory capital and leverage ratio requirements.
- 33 The following suggestions were made:
- (a) One respondent indicated that, it would be helpful if EFRAG could make an explicit recommendation for the European lawmakers to consider whether the EU Capital Requirement Regulation (CRR) needs to be amended in order to safeguard the existing capital position until such time as the interaction of IFRS 16 with the prudential regulatory framework is addressed both at international and EU level. The changes to the CRR must be introduced in time to be aligned with the IFRS 16 implementation date in the EU;
  - (b) One respondent suggested that 'EFRAG should recommend to the European Commission, before it considers finalising its endorsement of IFRS 16, to 'petition the Basel Committee to know the prudential treatment of ROUs';
  - (c) One respondent suggested to clarify some the assumptions considered by the EBA in preparing its quantitative analysis of the impact of IFRS 16 on a sample of 65 banks (paragraph 139 and following of Appendix 3). In particular:
    - (i) That the baseline scenario considered by the EBA included a risk weight of 100% for the right-of-use assets. The EBA quantitative analysis does not show the estimated impact due to a deduction of right-of-use assets from own funds (if considered intangible assets), being one of the alternatives discussed to date;
    - (ii) That a 3% discount rate was used to estimate the present value of the future lease obligations.

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

- 34 Considering the support expressed by the vast majority of respondents for the views expressed by EFRAG in its DEA, it is proposed to maintain in the Final Endorsement Advice the initial assessment that IFRS 16:
- (a) Meets the qualitative characteristics of relevance, reliability, comparability and understandability, leads to prudent accounting, and is not contrary to the true and fair view principle; and
  - (b) Would improve financial reporting and would reach a cost-benefit trade-off that is acceptable. EFRAG has not identified that IFRS 16 would have major deleterious effects on the European economy, including financial stability and economic growth. Accordingly, EFRAG has assessed that adopting IFRS 16 is conducive to the European public good.
- 35 The EFRAG Secretariat notes that most of the issues reported by constituents have already been included in the DEA. In particular the cover letter to the DEA refers to:
- (a) The high importance to some constituents of a timely endorsement;
  - (b) The need to clarify the interactions of IFRS 16 with regulatory capital requirements (although the Secretariat proposes to clarify that the EBA study, which concludes that the impact is of “rather limited significance”, makes an assumption about the prudential treatment of the right-of-use asset – see paragraph 36(b) below);
- 36 The EFRAG Secretariat however considers that the drafting of the Final Endorsement Advice could be further improved with some of the input received by:
- (a) Reporting the additional elements quantification of cost concerns provided by some respondents (paragraph 225 of Appendix 3) while reiterating the fact that EFRAG has received some broad and indicative estimates of the expected costs and any such estimates are necessarily subject to a high degree of uncertainty; and
  - (b) Clarifying the assumptions used by the EBA in analysing the quantitative effects of IFRS 16 on regulatory capital requirements (paragraph 139 of Appendix 3).
- 37 The EFRAG Secretariat considers that it is not within EFRAG’s remit to suggest any particular course of action to the European Commission (or other institutions) in relation to prudential regulation. Instead, EFRAG’s role should be limited to highlighting the concern raised.
- 38 Regarding the suggestions made by a few respondents to clarify or change some of the requirements in IFRS 16 (such as the application of the ‘right of substitution’), the EFRAG Secretariat understands that EFRAG’s remit is to assess the Standard issued by the IASB against the endorsement criteria. EFRAG’s remit does not extend to proposing ways to make IFRS 16 a ‘better standard’.

**Questions to the EFRAG Board**

- 39 Does EFRAG Board have comments on the feedback received from constituents and the proposed changes to the Endorsement Advice?
- 40 Does EFRAG Board approve the Final Endorsement Advice, as contained in Agenda Paper 07-02?

**Agenda Papers**

- 41 In addition to this cover note, agenda paper 07-02 –Letter to the European Commission Regarding the Endorsement of IFRS 16 *Leases* (marked-up for changes to the Draft Endorsement Advice) has been provided for the session.

**Appendix 1 – List of respondents to the Draft Endorsement Advice**

<b>Name of respondent</b>	<b>Country/ Region</b>	<b>Category</b>
BDI Federation of German Industries	Germany	Preparers and organisation of preparers
UK FRC	UK	Standard setters and accounting organisations
BASF SE	Germany	Preparers and organisation of preparers
Allianz	Germany	Preparers and organisation of preparers
CFA Institute	International	Users and organisations of users
ICAEW	UK	Standard setters and accounting organisations
Deutsche Telekom	Germany	Preparers and organisation of preparers
EFFAS	Europe	Users and organisations of users
ASCG	Germany	Standard setters and accounting organisations
Fresenius SE	Germany	Preparers and organisation of preparers
Bayer	Germany	Preparers and organisation of preparers
Commerzbank	Germany	Preparers and organisation of preparers
Pro7Sat1	Germany	Preparers and organisation of preparers
Merck	Germany	Preparers and organisation of preparers
Fresenius Medical Care (FMC)	Germany	Preparers and organisation of preparers
Deutsche Post DHL	Germany	Preparers and organisation of preparers
Accountancy Europe (formerly FEE)	Europe	Standard setters and accounting organisations
FSR (Danish Auditors)	Denmark	Standard setters and accounting organisations
SAP SE	Germany	Preparers and organisation of preparers
Orange	France	Preparers and organisation of preparers
ASSILEA	Italy	Leasing organisation
ANC	France	Standard setters and accounting organisations
ASF	France	Leasing organisation
European Savings and Retail Banking Group	Europe	Professional organisations
CRUF Global	International	Users and organisations of users
Daimler AG	Germany	Preparers and organisation of preparers
EBF	Europe	Professional organisations
FBF	France	Preparers and organisation of preparers
The Swedish Enterprise Accounting Group (SEAG)	Europe	Preparers and organisation of preparers