

EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

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Application of IFRS 16 Leases by SMEs

Objective

- 1 This paper considers two issues arising in developing the draft endorsement advice on IFRS 16 *Leases*:
 - (a) The extent to which unlisted SMEs are likely to apply IFRS 16; and
 - (b) Whether IFRS 16 is proportionate to SMEs.

Background

- 2 In its request for advice on the endorsement of IFRS 16, the European Commission included the following:

In particular, EFRAG should analyse how IFRS 16 could affect small and medium-sized enterprises (SMEs) that use IFRS under Article 4 and 5 of the IAS Regulation or to meet reporting requirements of non-regulated markets. For instance, is IFRS 16 appropriate for SMEs? Will the impact of IFRS 16 on the lease industry have any knock-on effects on SMEs' access to leasing as a source of finance?
- 3 Articles 4 and 5 of the IAS Regulation address:
 - (a) The consolidated accounts of public traded companies (Article 4); and
 - (b) Options in respect of annual accounts and of non-publicly-traded companies (Article 5).
- 4 This paper focusses on the options for Member States, under Article 5, to require companies whose publicly traded companies that are not groups and companies other than those addressed in Article 4 to apply IFRS adopted in the EU. Specifically, this paper focusses on SMEs, as defined in the EU.

Use of IFRS by European SMEs

- 5 During the comment period to EFRAG's Preliminary Consultation Document, the EFRAG Secretariat has conducted additional work and sought information from Member States and other sources in Europe to identify:
 - (a) the extent to which SMEs apply IFRS under various Member States' options in the IAS Regulation; and
 - (b) the extent to which SMEs reporting under IFRS are using leases.

Use of IFRS by SMEs not listed on a regulated market

- 6 EFRAG Secretariat has reached out to all Member States (and the European Economic Area) through National Standard Setters and the Accounting Regulatory Committee to seek information on the number of entities, not listed on a regulated market, reporting under IFRS under Member State's options.
- 7 There are about 23 million SMEs in the European Union and European Economic Area¹ and, according to ESMA², about 6,000 of them are listed either on a regulated or a non-regulated market.
- 8 Information has been obtained for 25 of the 28 EU countries and for 1 of the 3 EEA countries and is summarised in Appendix 1.
- 9 The feedback received suggests that the number of SMEs using IFRS, for their individual and/or consolidated financial statements, is generally low and does not exceed 1% of total SMEs in most of the EU and EEA countries.
- 10 Although Member State options have been applied in a variety of ways, only one Member State (Cyprus) requires all entities to apply IFRS. However, the use of leases is not widespread: only about 7% of Cypriot SMEs reported leasing according to the 2015 *Survey on the Access to Finance of Enterprises Report*³ issued by the European Central Bank and the European Commission (the 2015 SAFE report).
- 11 Based on the above, EFRAG Secretariat has concluded that IFRS 16 is expected to directly affect a limited number of SMEs in Europe.
- 12 EFRAG Secretariat has however heard concerns, expressed by some organisations of SMEs, about the possible indirect effects that IFRS 16 could have on local GAAP or tax legislation. The issue has been brought to the attention of National Standard-Setters working with EFRAG. However, the decision to introduce changes in their local GAAP or tax legislation is the exclusive competence of Member States and therefore is not part of EFRAG's assessment

Use of leasing by European SMEs

- 13 EFRAG Secretariat reached out to various European organisations of listed and non-listed SMEs including:
 - (a) The Quoted Companies Alliance;
 - (b) MiddleNext; and
 - (c) The European Federation of Accountants and Auditors for small and medium-sized enterprises,
- 14 EFRAG Secretariat also reviewed available surveys and other publications on access to financing by SMEs in the European Union.
- 15 From the reports reviewed and the interviews conducted with organisations of SMEs, European SMEs may have a greater recourse to leasing than larger businesses. In particular, the 2015 SAFE Report reported leasing as the third most important source of financing after credit line or overdraft and bank loans. Further, the 2015 report *The Use of Leasing Amongst European SMEs* showed that about 40% of SMEs used leasing and about 17% of total SMEs' investment was financed by leasing. However, the report does not indicate the proportion of respondents that are IFRS preparers.

¹ Source; Eurostat 2012.

² Securities and Markets Stakeholder Group – Report to ESMA Helping Small and Medium Sized Companies Access Funding

³ Survey on the access to finance of enterprises (SAFE) - Analytical Report 2015

- 16 The main reasons reported for SMEs to use leases was the flexibility they provided and the predictability of cash flows.

Conclusion

- 17 The number of SMEs likely to apply IFRS 16 is expected to be limited throughout the European Union. However, the extent of recourse to leasing by SMEs as a means of financing makes it necessary to further assess whether the effects of IFRS 16 will be proportionate to those SMEs that will apply IFRS.

Is IFRS 16 proportionate to SMEs?

Legal background and references

IFRS

- 18 The Conceptual Framework does not require accounting requirements to be proportionate. Paragraph Q35 of the Conceptual Framework notes that cost is a pervasive constraint on the information that can be provided by financial reporting, and that it is important that the costs of reporting information are justified by the benefits of reporting that information.
- 19 The IASB has published the *IFRS for SMEs*, which provides a form of proportionate reporting requirements. It should be noted that the definition of SME in the *IFRS for SMEs* relies on public accountability (as defined), while the European definition is substantially based on the size of the entity.
- 20 Paragraphs BC44 to BC46 of the *IFRS for SMEs* notes that in the IASB's judgement, the nature and degree of the differences between full IFRS and IFRS for SMEs must be determined on the basis of users' needs and cost-benefit analyses. They also note that users of financial statements of non-listed entities may have greater interest in short-term cash flows, liquidity, balance sheet strength and interest coverage, than they do in information that assist to assess the prospects for long-term cash flows, profit or loss or value.

European Union legislation

- 21 The treaty of the European Union refers to 'proportionality' in article 5. According to the proportionality principle, actions should be restricted to what is strictly necessary to achieve the objectives of the Treaties.
- 22 This notion is referred to in the Accounting Directive. The Directive takes into account the Commission's better regulation programme, and, in particular, the Commission communication *Smart Regulation in the European Union*, which aims at designing and delivering regulation of the highest quality whilst respecting the principles of subsidiarity and proportionality and ensuring that administrative burdens are proportionate to the benefits they bring. The Commission communication *Think Small First – Small Business Act for Europe*, adopted in June 2008 and revised in February 2011, recognises the central role played by SMEs in the Union economy and aims to improve the overall approach to entrepreneurship and to anchor the "think small first" principle in policy making. The European Council of 24 and 25 March 2011 welcomed the Commission's intention to present the "Single Market Act" with measures creating growth and jobs, bringing tangible results to citizens and businesses.

- 23 The preamble to the Accounting Directive adds that, in order to avoid disproportionate administrative burdens on small undertakings, Member States should only be allowed to require a few disclosures by way of notes that are additional to the mandatory notes. In the case of a single filing system, however, Member States may in certain cases require a limited number of additional disclosures where these are explicitly required by their national tax legislation and are strictly necessary for the purposes of tax collection. It should be possible for Member States to impose requirements on medium-sized and large undertakings that go further than the minimum requirements prescribed by this Directive.
- 24 The IAS Regulation does not include a notion of 'proportionality'. In the context of the IAS Regulation, EFRAG does not have an explicit option to recommend endorsement of a Standard but to exclude from its application a subset of the entities that fall within the scope of article 4 of the IAS Regulation, such as (for instance) companies of a smaller size.

How proportionality can be assessed

- 25 In relation to accounting Standards, proportionality could mean different things:
- (a) Whether the administrative burden will be proportionally bigger for SMEs;
 - (b) Whether the accounting impact will be proportionally bigger for SMEs – for instance, whether the relative increase in reported liabilities will be bigger;
 - (c) Whether the business impact will be proportionally bigger for SMEs – for instance, whether the cost of capital for SMEs will increase proportionally more than for non-SMEs.
- 26 The outcome of these three assessments will not necessarily coincide. For instance, an SME could have a very material lease over its office premises that was previously accounted for as an operating lease. The recognition of the lease would have a significant impact in percentage terms on the total liabilities but the administrative burden would not be excessive if the contract itself is fairly simple.
- 27 Conversely, if a SMEs has a large number of lease agreements (that do not qualify for the exemptions), this can be a proportionally bigger administrative burden for these entities that are likely to have a smaller accounting department. However, if the investors were already adjusting the reported numbers based on the notes, there is no reason to assume that the business impact would be different than for a bigger entity.
- 28 The following paragraphs successively analyse the different aspects of proportionality detailed in paragraph 25, and in particular:
- (a) how IFRS 16 addresses the cost constraint and whether the resulting administrative burden will be proportionate for SMEs (paragraphs 30 to 44); and
 - (b) a quantitative simulation of the accounting impact of IFRS 16 on SME (paragraphs 45 to 54);
- 29 The assessment of the business impacts of IFRS 16 on SMEs will largely draw on the study commissioned by EFRAG with an economic consultancy which is not complete at the time of this paper. When complete this study is expected to provide significant input into the economic impact of IFRS 16 on SMEs in particular regarding lease availability or lease pricing for SMEs.

How IFRS 16 addresses the cost constraint

- 30 Compared to IAS 17 *Leases*, IFRS 16 reduces the administrative burden by removing the need to classify leases between operating and finance leases. In some cases, this assessment required significant time and judgment. Entities were also

required to provide disclosure on operating leases, which required the collection of relevant information.

- 31 On the other side, IFRS 16 adds complexity for the treatment of leases previously treated as operating because it requires an entity to:
- (a) Assess the implicit rate in the lease, although the lessee can fall back to its incremental borrowing rate if the implicit rate cannot be readily determined;
 - (b) Assess the lease term – which can be more or less complex depending on the existence of options to extend or terminate; and
 - (c) Reassess lease liabilities and assets when payments vary depending on indexes or rates.
- 32 However, IFRS 16 contains a number of simplifications aimed at reducing the application costs on an on-going basis:
- (a) The short-term exemption;
 - (b) The exemption for leases of assets with low value; and
 - (c) The option to allocate all the contract payments to the lease component.
- 33 None of these exemptions are specifically aimed at SMEs. However, in general terms it can be argued that simplifications are likely to be more beneficial to entities with smaller accounting departments and/or less specialised accounting skills.

EFRAG Secretariat analysis

- 34 In order to test whether IFRS 16 is proportionate to SMEs, the first step is to identify what factors are likely to create a bigger administration burden when applying IFRS 16 and then to assess whether these factors are likely to be more prevalent for SMEs.
- 35 It should be noted that qualifying as an SME under the EU legislation is based on meeting specific quantitative thresholds. Our analysis cannot attain this level of precision. Hence, in the rest of the paper we refer in generic terms to 'smaller entities', which does not coincide exactly with SMEs.
- 36 Further, IFRS 16 does not introduce a new accounting model. Instead it requires that, broadly, 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 well known by all entities (including smaller entities) that already report under IFRS,
- 37 In EFRAG Secretariat's view, the factors likely to have the greatest impact on the administrative burden are:
- (a) The volume of operating lease transactions the entity has entered into and whether they qualify for the short-term exemption or the exemption for leases of assets of low value;
 - (b) The complexity of the entity's operating leases. Sources of complexity are:
 - (i) Determination of the discount rate(s);
 - (ii) Inclusion of options to extend or terminate;
 - (iii) Inclusion of variable payments based on indexes or rates;
 - (iv) Inclusion of significant service components (if the entity decides not to use the option in paragraph 20(c) above);

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- (v) Inclusion of non-standard terms and conditions (for instance, non-standard protective rights for the lessors that may impact the assessment of the existence of a lease).
 - (c) Interrelation with other aspects, such as the local tax laws.
- 38 No comprehensive data are available on the types of leases and nature of assets leased by these entities. Organisations of SMEs have indicated to the EFRAG Secretariat that, in their views, SMEs use leases to finance a wide range of asset types including premises, vehicles, plant and machinery, ITC, and office equipment. Service components, when included, are often only ancillary.
- 39 This feedback is confirmed by the Oxford Economics 2015 report *The Use of Leasing among European SMEs* which identified the three most common types of leased assets by SMEs to be machinery and industrial equipment; passenger cars and light commercial vehicles; and ICT and office equipment, these categories accounting for about 65% of the total. While no further breakdown is available, most (if not all) of the assets in these classes are unlikely to qualify for the low value asset exemption with the possible exception of office equipment. Representatives of the leasing industry have argued that the exemption is unlikely to be very effective as the average value of underlying asset exceeds the threshold indicated in the Basis for Conclusions of IFRS 16.
- 40 Further, SMEs organisations have confirmed that SMEs generally enter into leases that are straightforward and do not include complex terms, although exceptions may exist in specific industries. They expected complexity 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
- 41 Given their lower level of resources, it is reasonable to expect smaller entities to rely proportionally more on suppliers to fully service leased assets; for instance, smaller entities are likely to have a smaller in-house IT department. This would result in the need to separate service components, unless the entity elects to allocate all payments to the lease component.
- 42 On the other side, it is also reasonable to expect smaller entities to use standard industry contracts with relatively simple terms and conditions more frequently than bigger entities.
- 43 The complexity brought by the interrelation with other legislation such as tax laws will differ across countries but there is no reason to believe that it will affect smaller entities proportionally more.

Conclusions

- 44 EFRAG Secretariat's overall conclusion is that there is no clear indication that the administrative burden from IFRS 16 is disproportionate to SMEs.

Quantitative assessment of the accounting impact of IFRS 16 on SMEs

- 45 The EFRAG Secretariat has performed an accounting impact simulation on SMEs applying IFRS that are either non-listed or listed on unregulated market based on the information available in a commercial database.
- 46 A first sample of both listed and non-listed entities included 487 entities from twenty countries and is based on data drawn from 2014 financial statements. The results from the study, which were included in EFRAG's Preliminary Consultation Document, show that:
- (a) the lease liability amounts to 817.7 million euro, representing 2.9% of total debt. However, the sample includes three finance companies that report very high debt (77% of the total sample), and 158 entities for which the net debt is zero. When these finance companies are excluded, the ratio rises to 9.8%;

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- (b) the right-of-use asset amounts 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 represents 0.3% of equity.

47 The conclusions that can be drawn from the study are:

- (a) the lease liability and the right-of-use asset created on transition to IFRS 16 may have a material, but not overwhelming, effect on the financial statements of entities included in the sample;
- (b) the impact on the samples of large listed entities and listed and unlisted SMEs are not dissimilar; and
- (c) the practice by some users of estimating the lease liability by applying a factor of 8 to operating lease cash flows seems to overestimate the lease liability, which confirms the findings of the IASB Effects Analysis.

48 EFRAG Secretariat acknowledges that the representativeness of such a sample would be limited but observes that this approach is consistent with the one used by the European Commission for its evaluation of the IAS Regulation.

Additional quantitative analysis conducted on SMEs listed on non-regulated markets

49 In its contact with organisations representing SMEs, EFRAG heard that the accounting impact on their profit or loss could be proportionally higher because these entities may have one or few predominant 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.

50 To verify that assessment, the EFRAG Secretariat expanded its quantitative analysis with a focus on SMEs that use IFRS to meet reporting requirements of non-regulated markets.

51 The sample examined included 186 such entities (most of which listed on the London AIM stock exchange) and showed a particularly high ratio between simulated lease liability and debt – 39% versus the average 4% of the large entities sample excluding Financials (see paragraph 19 above). The reason for this high ratio was that the reported debt for a significant number of these entities was zero. This could be due to the fact that some of these entities had just been listed in the reference year.

52 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.

53 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 part 1 above. When entities from the Financials industry are excluded, the ratio for the sample is 12.1% in average, with a median of 11.7%.

54 The additional analysis seems to mitigate the perception that the accounting impact for these entities will disproportionately be more significant.

Conclusion on proportionality

55 The EFRAG Secretariat's tentative conclusion is that there is no evidence that the administrative burden arising from IFRS 16 or the accounting impacts will be disproportionate to SMEs.

- 56 Regarding the economic and business impacts, as mentioned in paragraph 29, the study commissioned with an economic consultancy is expected to provide additional input when completed. However, the first indications (see Progress Report provided as background online in Agenda paper 06.04) are that the implementation of IFRS 16 has a low likelihood of triggering a material change in leasing availability and lease pricing for SMEs.

Appendix 1: Extent of use of IFRS by European SMEs

57 The table below has been prepared based on the input provided by National Standard-Setters in Europe. Where no input has been received, data has been searching the ORBIS global company database.

Country	Number of SMEs ⁴	Member states options for entities that are not listed on regulated markets		% of SMEs using IFRS	
		Consolidated accounts	Annual accounts	Consolidated accounts	Annual accounts
Austria	308411	Permitted for all	NA (not permitted)	< 1%	Not permitted
Belgium	566006	Required for some/ permitted for all others	Required for some	< 1%	
Bulgaria	312608	Required for some/ permitted for all others	Required for some/ permitted for all others	less than 2%	
Croatia	148573	Required for some	Required for some	Data not available	
Cyprus	46139	Required for all	Required for all	100.0%	
Czech Rep	1007441	Permitted for all	Permitted for some	Data not available	
Denmark	213358	Permitted for all	Permitted for some	< 1%	
Estonia	58408	Required for some/ permitted for all others	Required for some/ permitted for all others	< 1%	
Finland	226373	Permitted for all	Permitted for some	< 1%	< 1%
France	2882419	Permitted for all	Not permitted	1% to 5%	Not permitted
Germany	2189737	Permitted for all	Not permitted	< 1%	Not permitted
Greece	726581	Permitted for all	Permitted for some	< 1%	< 1%
Hungary	528519	Permitted for all	Not permitted	< 1%	NA
Ireland	146741	Permitted for all	Permitted for all	< 1%	1% to 5%
Italy	3825458	Required for some/ permitted for some	Required for some/ permitted for some	< 1%	< 1%
Latvia	91939	Required for some/ permitted for some	<i>Required for some</i>	< 1%	< 1%
Lithuania	141893	Required for some/ permitted for some	Required for some/ permitted for some	< 1%	< 1%
Luxembourg	29265	Permitted for all	Permitted for all	< 1%	< 1%
Malta	26796	Required for some/ permitted for all others	Required for some/ permitted for all others	< 1%	< 1%
Netherlands	862697	Permitted for all	Permitted for some	1% to 3%	
Poland	1519904	Required for some/ permitted for some	Permitted for some	< 1%	< 1%
Portugal	793235	Required for some/ permitted for some	Permitted for some	Data not available	
Romania	425731	Required for some/ permitted for some	Required for some	< 1%	

⁴ Source: Eurostat – 2012.

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Country	Number of SMEs ⁴	Member states options for entities that are not listed on regulated markets		% of SMEs using IFRS	
		Consolidated accounts	Annual accounts	Consolidated accounts	Annual accounts
Slovakia	398392	Required for all	Required for some/ permitted for some	< 1%	
Slovenia	119644	Required for some/ permitted for all others	Required for some/ permitted for all others	< 1%	< 1%%
Spain	2385077	Required for some/ permitted for all others	Not permitted	< 1%	Not permitted
Sweden	661822	Permitted for all	Not permitted	< 1%	< 1%
UK	1703562	Permitted for some	Permitted for some	< 1%	< 1%
Total EU 28	22346729				

Iceland	nd	Required for some/ permitted for some	Required for some/ permitted for some	Data not available	
Liechtenstein	nd	Permitted for all	Permitted for all	Data not available	
Norway	278899	Permitted for all	Permitted for all	0.1255%	0.2044%
EU and EEA	22625628				