

AGENDA PAPER

IFRS Foundation Trustees meeting – Due Process Oversight Committee

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IFRS 16 Leases: Quality control – the process from permission to ballot to publication

Introduction

1. The purpose of this paper is to provide the DPOC with a summary of the steps taken in finalising the preparation of IFRS 16 *Leases* (and the accompanying effects analysis) since the International Accounting Standards Board (‘the Board’) gave its permission to ballot the Standard at its March 2015 meeting and the Committee considered the due process lifecycle review of the project at its meeting in April 2015 (Agenda Paper, AP 3C for that meeting refers¹).
2. The paper is primarily for information, but any questions and/or comments from Committee members would be welcome. As noted in AP1B(i) in the plenary session for this Trustees’ meeting, a number of respondents to the Trustees’ Request for Views consultation document (‘the RfV’) on the review of structure and effectiveness have made comments about the Board’s ‘quality control’ procedures when finalising a Standard² and the importance of the Board preparing an effects analysis³.

Background

3. The *Due Process Handbook* (paragraph 2.12) requires that the DPOC reviews and evaluates the evidence provided by the Board of compliance with the established due process. Before any new or amended Standard is finalised, the DPOC confirms that it has completed its review of due process. As noted above, the DPOC carried out a lifecycle review of the due process on the leases project at its April 2015 meeting and concluded that all necessary due process steps had been followed and that its review of due process was complete⁴.

¹ AP 3C from the April 2015 DPOC meeting can be accessed at: http://www.ifrs.org/Meetings/MeetingDocs/Trustees/2015/April/AP3C%20DPOC_LeasesLifecycleReview.pdf.

² Paragraphs 35-37 of AP1B(i) refer.

³ Paragraph 58(b) of AP1B(i) refers.

⁴ The report of the April 2015 is available at: <http://www.ifrs.org/DPOC/meetings/Documents/2015/Report-of-Apr-2015-DPOC-meeting.pdf>.

4. IFRS 16 was published on 13 January 2016. The publication ‘package’ of material that has been balloted and approved by the Board comprised:
 - a. the Standard (including consequential amendments to other Standards);
 - b. the Basis for Conclusions;
 - c. Illustrative Examples; and
 - d. an Effects Analysis (on which more below).

5. Other material issued with the Standard, other than a press release, comprised:
 - a. a Project Summary and Feedback Statement, which includes an explanation of how the Board responded to the most significant feedback received throughout the project⁵;
 - b. a video, as part of a new ‘Debrief’ series, in which the Board Chair Hans Hoogervorst introduces the Standard, and discusses the new requirements; and
 - c. (scheduled to be issued in the week beginning 18 January 2016) an Investor Perspectives article *IFRS 16—Shining light on leases*.

Quality control process after permission to ballot

6. The *Due Process Handbook* sets out the process to be followed in preparing a Standard (or other authoritative document) for publication, in terms of:
 - a. balloting ie the formal process by which Board members assent to the publication (paragraphs 3.22 to 3.30). This usually incorporates a pre-ballot stage before the formal ballot procedure begins, where the technical staff prepare one or more pre-ballot drafts, in response to which the Board members provide drafting comments. As part of the balloting process, the *Due Process Handbook* highlights that the aim is to develop Standards that are clear, understandable and enforceable and to provide guidance that is consistent with a principle-based approach. In drafting, the technical staff are charged with liaising with the IFRS Foundation’s Translations and Taxonomy staff to ensure that the proposed Standard can be translated into other languages and incorporated easily into the IFRS Taxonomy; and
 - b. drafts for editorial review – whereby the Board normally seeks input on the drafting from external parties (paragraphs 3.31 to 3.33). The *Due Process Handbook* gives the Board the flexibility to determine which external parties are asked to review the draft and also whether the draft is made publicly available on the website. While the Board has discretion as to the nature of the external review, the *Due Process Handbook* is clear in specifying the limited purpose of the draft

⁵ The Project Summary and Feedback Statement can be accessed at: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/IFRS_16_project-summary.pdf.

for external review and the fact that it does not constitute, nor is a substitute for, a formal step in the due process.

Balloting the Leases Standard and other material

7. In drafting the text of the *Leases* Standard, the technical staff first prepared a preliminary draft of the requirements relating to the definition of a lease and accompanying Illustrative Examples, which was shared with a limited number of external parties. The technical staff, in consultation with the leases board advisors, decided to include this step to improve the quality of the drafting—they anticipated that the definition requirements and examples would be the most complicated to draft and are an important part of the Standard.
8. Following this, the technical staff prepared a first pre-ballot draft, on which the Board members, senior technical staff, and the Taxonomy team provided comments. An external review draft was then prepared, taking into consideration comments received on the first pre-ballot draft, on which a selected group of reviewers provided comments (more below).
9. The technical staff then prepared a second pre-ballot draft, taking into consideration comments received from external reviewers, which was made available to the parties listed earlier regarding the first pre-ballot draft, as well as the Translations team. Of particular note is that a senior technical staff member, with knowledge of the project but independent from the project team, reviewed the second pre-ballot draft.
10. After this, a ballot draft was prepared for the Board (and reviewed also by the Executive Technical Director, a Technical Director and the Taxonomy team), with a post-ballot draft also being circulated.

Analysis of drafting comments received

11. The technical staff documented all comments received at each stage of the drafting process, carefully considered each comment and provided individual responses to each of the comments received. Those responses noted whether the text was changed to address the particular comment and, if the text was not changed, an explanation as to why the existing text was considered better than any suggestion made. Those comments and responses were made available to board members and the technical directors.
12. At each stage, the technical staff consulted extensively with the leases board advisors, discussing (a) any substantive changes made to the text, (b) any significant comments (or concentration of comments) received that did not result in changes to the text, and (c) whether any comments identified sweep issues that should be discussed with the Board

at a public board meeting. The Board discussed a number of sweep issues identified during the drafting process at its October 2015 meeting.

Draft for external review

13. As noted above, the technical staff made an external review draft of the Standard available to a selected group of reviewers, including the seven major accounting firms, a number of companies, standard-setters, regulators and members of the Leases Working Group. The technical staff also requested and received comments from selected investors and analysts on the text of the disclosure requirements and associated illustrative examples.
14. As part of this process, the accounting firms raised some concerns (including with Jim Quigley) that they felt that their comments were not being given due consideration in drafting the Standard. The technical staff would like to reassure the DPOC that all of the firms' comments were tabulated, analysed and considered carefully (as where those from other external reviewers), including comments on the definition by the staff of both the Board and the US Financial Accounting Standards Board ('FASB') (given that this has been a joint project), as well as members of the Boards, and a number of changes were made. The technical staff also had follow-up conversations with a number of external reviewers (including the accounting firms) to obtain a better understanding of some of their comments—some of these included discussions about the amended text proposed by the staff to address the comments raised.
15. The technical staff and the Board have been at pains to take forward the drafting in a careful and considered way. DPOC members will recall the correspondence received from the European Financial Reporting Advisory Group (EFRAG) on the subject of the Board's quality control procedures prior to the issue of a final Standard or major amendment to a Standard, which was considered at the meeting held in February 2015 (AP2F for that meeting refers⁶). EFRAG called for improvements to be made to the Board's process when finalising a Standard, including undertaking public 'fatal flaw' reviews prior to finalisation. Having considered the issue at that meeting, Michel Prada replied to EFRAG noting a number of improvements to the quality control procedures, including – where appropriate – 'cold reviews' of pre-ballot drafts by senior technical staff and an independent external review by a former standard-setter. Given these, the DPOC view was to retain the current flexibility in the *Due Process Handbook* rather than require a mandatory fatal flaw review⁷.

⁶ AP2F for the DPOC's February meeting can be accessed at:

⁷ Michel Prada's letter of xx to EFRAG Acting President Roger Marshall can be accessed at:

16. In its response to the RfV on the review of structure and effectiveness, EFRAG has again referred to the suggestion of having a public fatal flaw review as part of the system of quality control in the process of finalising Standards. Other respondents, in particular the major accounting firms, have also emphasised the importance of quality control in the finalisation stage and called for further improvements, although most do not advocate a public fatal flaw review.

Effects analysis

17. As the DPOC is aware, an effects analysis has to be prepared and be approved by the Board. A comprehensive effects analysis (over 100 pages long) has been prepared for IFRS 16 and is available on the website⁸. It is the first effects analysis to be issued with a final Standard that seeks specifically to start incorporating the recommendations of the report of the Effects Analysis Consultative Group ('the EACG') that was published in November 2014⁹. The table at Appendix A sets out how the EACG's recommendations have been reflected in the *Leases* Effects Analysis report.
18. On the issue of effects analysis more generally, the technical staff are developing a framework and a tool for staff to use to help them further embed effects analysis into the whole process of the development of Standards in a way that implements in full the recommendations of the EACG. That remains a work-in-progress and the staff plan to report progress to the DPOC at future meetings.

⁸ The IFRS 16 effects analysis can be accessed at: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/IFRS_16_effects_analysis.pdf.

⁹ The report of the Effects Analysis Consultative Group can be accessed at: http://www.ifrs.org/About-us/IASB/Advisory-bodies/Working-groups/Effects-Analysis-Consultative-Group/Documents/Effects%20Analysis%20Consultative%20Group_Report_November%202014.pdf.

Appendix A

How the *Leases* effects analysis reflects the recommendations of the Effects Analysis Consultative Group

EACG recommendations	<i>Leases</i> Effects Analysis report
<p>The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. The focus of the IASB’s assessment should be on how a proposed financial reporting change is likely to affect that objective. The IASB is not required to assess possible broader economic consequences because these are beyond its objective.</p> <p>Changes to IFRS are expected to lead to better decisions by investors relying on these reports. Changes to reporting requirements can also cause preparers to bear costs in complying with IFRS and users of the financial reports to bear costs to absorb and process the new information.</p> <p>The IASB should assess and explain how general purpose financial reports are likely to change because of the new requirements, and why those changes will improve the quality of general purpose financial reports. The IASB should also explain why it considers those changes to be justifiable, by demonstrating how it assessed the likely effects on the direct costs to preparers of meeting the new requirements and the related costs to users.</p>	<p>The <i>Leases</i> Effects Analysis report (‘the report’) makes clear that the focus of the Board’s assessment is on how the financial reporting changes set out in IFRS 16 is likely to affect the objective referred to by the IASB.</p> <p>The ‘Introduction’ section of the report (page 9) notes that, in evaluating the likely effects of IFRS 16, the Board has considered:</p> <ul style="list-style-type: none"> (a) how activities will be reported in the financial statements of those applying IFRS; (b) how comparability of financial information will be improved both between different reporting periods for the same entity and between different entities in a particular reporting period; (c) how the ability of users of financial statements to assess the future cash flows of an entity will be improved; (d) whether better economic decision-making as a result of improved financial reporting will be achieved; (e) the effects on the compliance costs for preparers; and (f) the effects on the costs of analysis for users of financial statements. <p>The report then includes information on:</p> <ul style="list-style-type: none"> • bullet (a) above in Section 6—<i>Effects on a company’s financial statements</i>; • bullets (b), (c) and (d) above in Section 4—<i>Benefits</i>; and • bullets (e) and (f) above in Section 5—<i>Costs</i>.
<p>The mandate of the FSB is to promote the stability of financial markets as a whole. The IASB focuses on ensuring that investors have</p>	<p>The report (Section 7.3, page 60) makes clear that the Board has considered the effect that IFRS 16 might have on regulatory capital</p>

EACG recommendations	<i>Leases</i> Effects Analysis report
<p>high quality, transparent and comparable information general purpose financial reports about individual entities.</p> <p>To help the FSB achieve its objectives, the IASB should, without compromising its own objectives, continue to engage with the FSB to ensure that the FSB is aware of proposed changes to financial reporting and has sufficient time to assess and address how changed financial reporting information should be incorporated into their monitoring systems.</p>	<p>requirements. It also makes clear (albeit without referring specifically to the FSB) that the Board continues to maintain an on-going dialogue with prudential regulators and other interested parties to raise awareness of the likely effects of IFRS 16.</p>
<p>The objective of general purpose financial reports prepared using IFRS is to provide financial information relevant to those making decisions about providing resources to the entity.</p> <p>The IASB recognises that other parties use general purpose financial statements for their own objectives—including determining taxable income, determining distributable reserves, statistical purposes and regulation.</p> <p>It is not the responsibility of the IASB to tailor financial reporting to meet the needs of these other parties. The IASB recognises, however, that it has an obligation to allow these other parties to observe changes to financial reporting that could have implications for their activities.</p> <p>It is important that the IASB maintains strong and open communication links with other accounting standard-setters for this purpose.</p>	<p>The ‘Introduction’ section of the report (page 8) provides a very high level summary of the extensive consultation that has taken place on the project, including three public consultations on its proposals to change lease accounting and the holding of hundreds of meetings, round tables and other outreach activities. This included extensive discussions with preparers (both lessors and lessees), users of financial statements, regulators, standard-setters and audit firms worldwide.</p> <p>Section 6 of the report (pages 41-53) summarises the Board’s assessment of the likely effects of IFRS 16 on a company’s financial statements, including effects on key financial metrics.</p> <p>Section 7 of the report (pages 55-63) outlines the Board’s assessment of the likely effects on a range of issues:</p> <ul style="list-style-type: none"> (a) the cost of borrowing; (b) debt covenants; (c) regulatory capital requirements; and (d) the leasing market and access to finance for smaller companies.
<p>Other accounting standard-setters may have responsibilities within their local jurisdiction regarding assessment of effects of a change in accounting standards. It is not the responsibility</p>	<p>As noted at the beginning of the report (page 2), the <i>Leases</i> project has been a joint project conducted by the IASB and the US Financial Accounting Standards Board</p>

EACG recommendations	<i>Leases</i> Effects Analysis report
<p>of the IASB to meet those requirements.</p> <p>However, the IASB should work co-operatively with local standard-setters so, where possible, it can plan its fieldwork and outreach in ways that are mutually beneficial for the IASB and those local jurisdictions.</p>	<p>(FASB).</p> <p>The report (Section 72, page 59) notes that the Board liaised with the European Financial Reporting Advisory Group (EFRAG) and a number of European national standard-setters on a public survey conducted during 2015 to obtain information as part of the consideration of the likely effects of IFRS 16 on debt covenants.</p> <p>The Board also asked the Accounting Standards Advisory Forum (ASAF) for advice on the content of the Effects Analysis, and how best to communicate the likely effects of the new <i>Leases</i> Standard—that advice was taken into account in preparing the Effects Analysis report.</p>
<p>The IASB should plan its fieldwork so that it is proportionate to the changes in financial reporting being proposed. Pervasive and significant changes generally warrant a more comprehensive assessment programme than is needed for narrow-scope changes.</p> <p>The type, and depth, of fieldwork undertaken should also reflect the stage of development of the project:...</p> <p>(c) at the finalisation of a Standard, the IASB is explaining the basis for its decisions and what it expects to be the effects of the changes to financial reporting requirements. Accordingly, the fieldwork and analysis should explain how the IASB has made its final decisions.</p>	<p>The report sets out the changes to accounting requirements introduced by IFRS 16 and the likely effects on:</p> <ul style="list-style-type: none"> (a) companies affected by changes in lease accounting – reporting on an analysis undertaken by the Board about listed companies’ leases until now classified as operating leases and the potential likely effects across a range of industry sectors, using a sample of companies (the likely impact on unlisted companies and Small and Medium-sized Entities, SMEs, is also examined); (b) the benefits to be achieved through improved quality and comparability of financial reporting, including analysis on the expected effects on reported financial leverage, current adjustments to financial statements made by investors and analysts and credit rating agency methodology for off-balance sheet leases; (c) estimates of both implementation costs and on-going costs, together with the results of the outreach performed to assess the effects of the exemption for

EACG recommendations	<i>Leases</i> Effects Analysis report
	<p>leases of low-value assets, and likely effects of the simplifications and practical expedients in the Standard. Appendix B to the report also includes case studies illustrating the steps to be taken by companies when implementing the Standard and where costs are likely to be incurred;</p> <p>(d) the financial statements, including the results of testing the effects of changes that might occur to a company’s lease portfolio. In addition, Appendix C to the report includes worked examples illustrating the likely effects on the financial statements, prepared using real company information; and</p> <p>(e) the other issues as set out in Section 7 of the report (as listed above), including reporting on the results of academic and other research and an analysis of survey results.</p>
<p>The IASB has a responsibility to give full and fair consideration to the perspectives of those affected by IFRS globally.</p> <p>The IASB should aim to undertake consultation that is geographically broad-based so that its Standards are written with principles that can be applied globally. Other accounting standard -setters can help by providing the IASB with analysis and information about effects in their jurisdiction generally as well as about factors that might be unique to their jurisdiction.</p> <p>However, the IASB must make its assessment from a global perspective and not make its decisions because of how the new requirements could affect a particular jurisdiction. There might be circumstances in which the net benefits of a new requirement are negligible (or even create a net burden) for entities within in a particular jurisdiction. The IASB’s assessment needs to be whether new financial reporting requirements are justifiable on a</p>	<p>The assessment set out in the report is made from a global perspective, although the Board has also included an analysis (in Section 8) of the effects of the differences between IFRS and US GAAP. In a number of places in the report (see Sections 3, 7.2 and 7.3), the reports of surveys and analysis undertaken on European entities are summarised, but the scope of these exercises is made clear.</p>

EACG recommendations	<i>Leases</i> Effects Analysis report
global basis.	
<p>The IASB should consider ways to increase the involvement of other accounting standard-setters in undertaking fieldwork locally and sharing the results with the IASB.</p>	<p>As noted above, the ‘Introduction’ section to the report provides a very high-level summary of the consultation process, referring to the extensive discussions with other accounting standard-setters (and other constituents). The <i>Leases</i> project page on the website provides details of the consultation undertaken with various groups and categories of stakeholder, and outreach in general.</p>
<p>The IASB should make available information about the nature of fieldwork and outreach it has undertaken. The IASB should take steps to ensure that fieldwork tools such as surveys and case studies are easily accessible on the project website. Such information should also include identifying as clearly and openly as possible, while respecting requests for confidentiality, who has participated in the fieldwork and the evidence that has been collected. This information should be made available throughout the development of the project.</p> <p>When it is not possible for the IASB to disclose the identities of individual participants in fieldwork, the IASB should provide as much information as it is able to for outside parties to be able to understand the profile of fieldwork participants.</p>	<p>Summaries of the outreach and fieldwork undertaken on the <i>Leases</i> project (including information about the participants) are available on the relevant project page on the website.</p>
<p>The format of the analysis of the likely effects of a proposed change in financial reporting should reflect the stage of the proposals...</p> <p>When a new Standard is issued, the IASB should generally prepare a separate Effects Analysis Report. A tightly-focused document that summarises the likely effects and how the IASB made the assessments can help those with a particular interest in this work. Any such report should be included with the package of documents balloted by the IASB.</p>	<p>A separate Effects Analysis Report has been prepared as part of the package of documents balloted by the Board. It has been issued with the package of material accompanying IFRS 16 published on 13 January 2016.</p>