Fact pattern

An entity has two lines of business:

Line A: Producing vehicles. After production, the vehicles are either sold or leased out via finance leases or leased out via operating leases. Line A contributes about 75% to the gross profit of the entity. Each of the three business activities within line A (i.e., selling, finance leases and operating leases) contributes about 1/3 to the gross profit of line A.

Line B: Service and maintenance. Line B contributes about 25% to the gross profit of the entity.

Therefore, each of the four business activities is significant.

The entity's segments are organised by region.

The entity uses (internally and externally) one gross profit-like performance indicator for business line A, one for business line B and one for the aggregate of the leasing activities (i.e., for finance leases and operating leases together).

While the lease arrangements do not differ significantly in nature, for accounting purposes some of them are classified as finance leases and others as operating leases, because some of them last over five years (major part of the economic life), others only over three years (not major part of the economic life). For each lease arrangement, regardless of whether it is a finance lease or an operating lease, a corresponding refinancing arrangement with a bank is entered into (in order to bridge the missing cash inflows compared to a sale), corresponding to the amount of the lease and the lease term. The refinancing arrangements generate significant interest expenses.

Question 1: Do operating lease-activities of a manufacturer lessor constitute a specified business activity of either "providing financing to customers" or "investing in assets"?

View 1: The operating lease activities in this fact pattern constitute a specified business activity "providing financing to customers".

> Providing financing to customers is not defined in IFRS 18 or other accounting standards. While *finance lease*-activities are mentioned as an example for providing financing to customers (B32(c)), proponents of this view believe that from an economic point of view, i.e., from the **business perspective** of the lessor, both finance leases and operating leases are similar in that respect that customers may use a product of the lessor over a period of time and they do not have to pay at the beginning of the period but rather over the period of use. Such a period of use can take several years even under operating leases. Hence, if providing financing to customers is understood as "use now, pay over time", under both forms of leases the customer is granted a form of financing. This view is supported by the fact that for both, finance leases and operating leases, the entity enters into re-financing arrangements to compensate the missing cash-inflow (compared to a sale) at the beginning of the period of use. This evidences that from the perspective of the lessor there is no difference whether the product is leased out by way of finance lease or by way of operating lease. Proponents of this view accept that operating leases are not mentioned in B32. However, since there is nothing explicit in the standard that would prohibit this view and since they believe, as described, both forms of leases provide financing to customers economically, finance lease activities and operating lease activities in this fact pattern can be seen together as one specified business activity "providing financing to customers". The fact that for accounting purposes under IFRS 16 finance leases and operating leases are treated significantly differently does not hinder this view, since proponents believe that the distinction between finance leases and operating leases

for accounting purposes is somewhat artificial and the border between these two forms is judgmental anyway.

View 2: The operating lease activities in this fact pattern constitute a specified business activity “investing in assets”.

Proponents of this view believe that operating lease-activities are not mentioned as an example for providing financing to customers in B32 for a good reason. The reason is that determining which leasing activities are a form of providing financing to customers and which are not, should not be answered from an economic perspective (as under view 1), but should rather be answered from an **accounting perspective**. For accounting purposes IFRS 16 distinguishes between finance leases and operating leases based on whether substantially all the risks and rewards are transferred. Only when this is the case, the asset is substantially bought by the customer, but payment from the customer is deferred. This equals a traditional understanding of “providing financing”. In contrast, under an operating lease the asset is not substantially bought by the customer. Hence this is not seen as “providing financing to customers” since the customers pays as it uses the asset.

However, proponents of this view believe that the operating lease activities constitute a specified business activity “investing in assets”. “Investing in assets” is just as undefined as providing financing to customers. Proponents of this view believe that (a) “investing” is neutral as to whether the assets are purchased by the lessor or produced by the lessor (in this case produced) and (b) it is a typical feature for investing in assets that the assets that are invested in generate a return individually which is given in the fact pattern. Hence, producing the assets and leasing them out is similar to purchasing securities and earning increases in value and/or dividends or producing investment properties and earning rental income from them.

View 3: The operating lease activities in this fact pattern do not constitute a specified business activity at all.

Proponents of this view believe that operating lease activities are not to be seen as “providing financing to customers” for the reasons given under view 2.

They believe that such activities are also not to be seen as “investing in assets” since the assets are not produced with the purpose of leasing them out. Rather, they are produced with the intention of selling them or leasing them out. This is different to a traditional understanding of investing in assets, which means that the asset invested in is not sold but used to earn income other than a selling profit. Also, in order to have a SMBA investing in assets, the entity must invest in assets that meet the definition of 53a, 53b- or 53-assets. Since the vehicles are the result of the production process using several resources of the entity, they do not meet the definition of 53c-assets (53a and 53b are not applicable anyway).

Question 2: Do the finance lease activities of a manufacturer lessor constitute a *main* business activity <u>under the example of B34</u> if they are monitored together with operating lease-activities? (The same question can be asked in relation to the operating lease activities that are monitored together with finance leases)

View 1: The finance lease activities in this fact pattern do not constitute a main business activity under the example of B34.

In accordance with B34, the usage of a gross profit-like subtotal is a strong indicator for a main business activity. However, as required by BC180, the subtotal should include (only) the income and expense of *that* activity (BC180 (emphasis added): “If an entity provides financing to customers as a main business activity, the difference between the interest revenue from *that* main business *activity* and the interest expense incurred to obtain the financing needed for *that* main business *activity* is an important measure of the entity’s operating performance (see paragraphs BC94–

BC102)”. Hence, in the fact pattern under review as the subtotal includes both, significant finance leases and significant operating leases, this subtotal is not a strong indicator under B34, because the subtotal monitored internally does not isolate that activity.

However, the absence of an indicator under B34 is not determinative for the question whether the business activity is a main business activity. It can nevertheless meet the requirements of B33.

View 2: The finance lease activities in this fact pattern constitute a main business activity under the example of B34.

In accordance with B34, the usage of a gross profit-like subtotal is a strong indicator for a main business activity. The standard itself does not require that the subtotal must only include income and expenses from that activity. Hence, the fact that a significant other activity is included does not harm. Hence, in the fact pattern under review the finance lease activities constitute a main business activity.

The impact

The assessment under questions 1 and 2 have, depending on the outcome, the following consequences:

- ***Scenario 1: Two different SMBAs***

If it is determined that the entity has two different SMBAs (one being “providing financing to customers” for the finance lease activities and the other being “investing in assets” for the operating lease activities) then:

- a respective disclosure is made (IFRS 18.51),
- the income and expenses from the finance leases are classified in the operating category (IFRS 18.B48(c)),
- the income and expenses from the operating leases are classified in the operating category (IFRS 18.58),
- interest income from cash & cash equivalents that relate to finance leases only is classified in the operating category (IFRS 18.56(b)(i)) and from others may be classified in the operating category (IFRS 18.56(b)(ii)), and
- interest expenses from financing liabilities that relate to finance leases (but not to operating leases) are mandatorily classified in the operating category (IFRS 18.65(a)(i)), and
- classification of interest-related cashflows follows the complex requirements in IAS 7.34B-34D, for which it is for example relevant whether interest income (and interest expenses respectively) in the statement of profit or loss are classified in a single category or in more than one category, which is influenced by the application of the provisions mentioned in the previous bullet points.

- ***Scenario 2: One SMBA for both leasing activities***

If it is determined that the entity has one SMBA (“providing financing to customers” for both, finance lease activities and operating lease activities) then

- a respective disclosure is made (IFRS 18.51),
- the income and expenses from the finance leases and from the operating leases are classified in the operating category (IFRS 18.B48(c)),
- interest income from cash & cash equivalents that relate to both, finance leases and operating leases is classified in the operating category (IFRS 18.56(b)(i)) and from others may be classified in the operating category (IFRS 18.56(b)(ii)), and

- interest expenses from financing liabilities that relate to both, finance leases and operating leases are mandatorily classified to the operating category (IFRS 18.65(a)(i)), and
- classification of interest-related cashflows follows the complex requirements in IAS 7.34B-34D.

- ***Scenario 3: One SMBA for finance leases only***

If it is determined that the entity has one SMBA ("providing financing to customers" for finance leases only) then:

- a respective disclosure is made (IFRS 18.51),
- the income and expenses of the finance leases are classified in the operating category (IFRS 18.B48(c)),
- interest income from cash & cash equivalents that relate to finance leases only is classified in the operating category (IFRS 18.56(b)(i)) and from others may be classified in the operating category (IFRS 18.56(b)(ii)), and
- interest expenses from financing liabilities that relate to finance leases (but not to operating leases) are mandatorily classified in the operating category (IFRS 18.65(a)(i)). Therefore, the lease term, among other factors, influences whether the interest expense of the lessor are part of the operating category (finance leases) or part of the financing category (operating leases), and
- classification of interest-related cashflows follows the complex requirements in IAS 7.34B-34D.

- ***Scenario 4: No SMBA***

If it is determined that the entity has no SMBA (e.g., because for the assessment under B34 view 1 (question 2) is applied and there is no other evidence under B33 available that would lead to a main business activity) then:

- no disclosure under IFRS 18.51 is made,
- the income and expenses from the finance leases are classified in the operating category (IFRS 18.B48(c)),
- the income and expenses from the operating leases are classified in the operating category or in the investing category, depending on whether the assessment under IFRS 18.53(c) (i.e. the "largely independent"-test) leads to operating assets or to non-operating assets.
- interest income from cash & cash equivalents is classified in the investing category (IFRS 18.53(b)), and
- interest expenses from financing liabilities that relate to finance leases and operating leases are classified in the financing category (IFRS 18.60), and
- classification of interest-related cash outflows to the cashflows from financing activities (IAS 7.34A(a).

The matter is widespread since it applies to all manufacturer lessors.

There is currently no clear view on questions 1 and 2 that would have emerged in practice, in literature or amongst auditors. Hence, diversity in practice is expected.