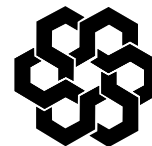

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2007, London**

Project: **Sale of assets held for rental (Agenda Paper 9(iii))**

Background

1. The IFRIC has received a request on the treatment of sales of assets held for rental (see appendix 3). As part of their business, companies such as motor vehicle dealerships, with a rental division, regularly purchase assets (vehicles in this case) and hold these assets for rental to third parties. This also occurs in various industries such as aircraft manufacturing, heavy equipment, shipping, property industry etc... Many of these entities are in fact in the business of selling these assets, as well as renting them out. This *dual intention*[1] is part of their business model, sales of such assets may occur on a regular basis and the renting and selling activities may be undertaken by separate divisions.

[1] Term used by the submitter

Issue

2. IAS 16 paragraph 68 states that gains arising from derecognition of an item of property, plant and equipment (PP&E) shall not be classified as revenue. The issue is whether, in the circumstances described above, the sale of such assets should be accounted for gross as revenue and cost of sales rather than as a net gain or loss in the income statement.

Staff analysis

Assessing diversity in practice

3. The staff found that, in various industries, there is some diversity of application of IFRSs in terms of presentation in financial statements. This diversity is geographically widespread in at least two industries: car rental and automotive manufacturing. It was not possible to reach a conclusion in other industries.

4. In the car rental industry, practitioners of the gross recognition of revenue and cost of sales argue that companies in this industry are in the business of renting cars and selling second-hand cars (dual intention). Usually, these companies have the infrastructure in place to sell the second-hand cars (e.g. a separate sales department). Sales of second-hand cars may be at a loss but, when aggregated with the cash-flows of the lease, the operation as a whole is a gain. Two streams of revenue are accounted for in the income statement. On the other side, those who recognise only a net gain or loss on the disposal of second-hand cars argue that they strictly apply IAS 16.68.

5. In the automotive manufacturing industry, the staff have analysed the financial statements of some major companies. Sometimes, sales of vehicles contain a buy-back guarantee given by the manufacturer to customers like car rental companies. From the manufacturer's perspective, these transactions are treated in substance as operating leases when the risks and rewards incidental to ownership have not been substantially transferred to the customer. Revenue is not recognised on delivery but spread over the period of the guarantee. Automotive manufacturers may also rent out vehicles to third parties under an operating lease agreement. In these circumstances, the underlying vehicles are assets of the manufacturers. However, presentation in their financial statements is not uniform. Some include these vehicles in inventories. By contrast, some recognise these vehicles as PP&E. In between, some account for them as inventories for

short-term contracts of less than one year and as PP&E for long-term contracts exceeding one year (see appendix 2). The decision to classify these transactions as inventories or as PP&E directly affects reported working capital and net debt. At the end of the lease or the buy back guarantee, manufacturers get back the vehicles and sell them on the market and account for revenue on the sale. There is also diversity of presentation in the income statement when the vehicles are classified as PP&E, as some account for the gross revenue and costs of sale and some for the net gain or loss within the item "other income (expenses)".

Analysing existing IFRSs

When an asset is acquired and leased

6. The first issue is whether a lessor should account for an asset under IAS 16 *Property, Plant and Equipment* or IAS 2 *Inventories*.

7. IAS 16 defines PP&E as tangible items that (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one period. The staff note that, generally, leased assets would be used during more than one period before being sold (e.g. leased vehicles), and would meet the definition of PP&E. The requirements of IAS 1 paragraph 57[2] would then apply for the classification as current or non-current.

8. IAS 2 paragraph 6 defines inventory as (a) assets held for sale in the ordinary course of business or (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. The staff note that i) this definition does not encompass leased assets ii) inventories are not expected to generate cash-flows until goods are sold or services are performed in accordance with IAS 18.

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[2] IAS 1 paragraph 57: an asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is expected to be realised within twelve months after the balance sheet date; or
(d) it is cash or a cash equivalent (as defined in IAS 7 Cash Flow Statements) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.

All other assets shall be classified as non-current.

9. The staff note that, in the context of this issue, underlying assets are initially rented out and would be within the scope of IAS 16. On the other hand, they also take the form of inventories, being held for sale in the ordinary course of business.

When the asset is disposed of immediately after the lease

10. The second issue is whether the revenue on disposal of assets previously rented under an operating lease and classified as PP&E should be accounted for gross (sales and cost of sales) or net (gains or losses).

11. The staff note that the notion "in the course of the ordinary activities" plays an important role in IAS 16, IAS 18, IAS 1 and the Framework for the presentation of gross or net revenue in the income statement within the net results of operating activities.

12. IAS 16 paragraph 68 states that the gain or loss arising from derecognition of an item of property, plant and equipment shall not be classified as revenue. The staff also noted that BC35 of IAS 16 was quite clear about the intention of the Board for such requirement (emphasis added):

    Although the Board concluded that an entity should apply the recognition principle for revenue from sales of goods to its recognition of gains on disposals of items of property, plant and equipment, the Board concluded that the respective approaches to income statement display should differ. <u>The Board concluded that users of financial statements would consider these gains and the proceeds from an entity's sale of goods in the course of its ordinary activities differently in their evaluation of an entity's past results and their projections of future cash flows. This is because revenue from the sale of goods is typically more likely to recur in comparable amounts than are gains from sales of items of property, plant and equipment</u>. Accordingly, the Board concluded that an entity should not classify as revenue gains on disposals of items of property, plant and equipment.

13. IAS 18 paragraph 7 defines revenue as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

14. Paragraph 32 of IAS 1 *Presentation of Financial Statements* states that "assets and liabilities, and income and expenses, shall not be offset unless required or permitted by a Standard or an Interpretation". Further, paragraph 33 states that "It is important that assets and liabilities, and income and expenses, are reported separately. Offsetting in the income statement or the balance sheet, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and

conditions that have occurred and to assess the entity's future cash flows". Then, paragraph 34 states that an entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. The results of such transactions are presented, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. For example: (a) gains and losses on the disposal of non-current assets".

15. The Framework gives interesting guidance under its Performance section:

> 72 Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.

16. **The ability of the entity to generate cash and cash equivalents in the future as opposed to incidental activities unlikely to recur on a regular basis appears to be the dividing line between transactions in the course of the ordinary activities and those that are not.** The Framework also states clearly that it is a matter of judgement ("consideration needs to be given to the nature of the entity and its operations").

17. The staff also found interesting the requirements of IAS 40 *Investment Property* paragraph 58: *"Paragraph 57(b) requires an entity to transfer a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the balance sheet) and does not treat it as inventory"*. This passage illustrates a case of change in use of an asset. To that extent, the staff note that IAS 40 dedicates a section for transfers and another one for disposals, while IAS 16 only deals with derecognition and remains silent on transfers.

When the asset is held for sale after the lease period

18. The presentation in the balance sheet will depend upon the classification of the asset during the lease period. If the asset was classified as non-current PP&E, the requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* would apply, as the scope of this Standard encompasses **all** non-current assets. Effectively, in BC 13 the Board noted that the classification and presentation requirements of this IFRS are applicable to all non-current assets and concluded that any exclusion should relate only to the measurement requirements. The staff note that, to that extent, there is an inconsistency between IFRS 5 and IAS 40. In IAS 40, a transfer to inventories is possible when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. On the other hand, all non-current assets fall in the scope of IFRS 5.

19. Non-current assets held for sale are to be presented separately from other assets in the balance sheet and, under paragraph 24, a gain or loss is to be recognised when the assets are derecognised in accordance with paragraphs 67-72 of IAS 16 and in particular paragraph 68, which requires recognition of the net gain or loss.

Staff recommendation

20. This issue is widespread and diversity arises in practice. To resolve it, the staff recommend the IFRIC to refer to the Board the issue of whether IAS 16 should be amended within its *Annual Improvements Process* to allow recognition of gross revenue and costs of sale in some limited circumstances. In doing so, the Board should consider whether revenue should be reported gross in the income statement when sales of assets previously rented out arise in the course of the ordinary activities and recur on a regular basis, following the rationale of :

    - the Framework paragraph 72, which states that, to distinguish between items that arise in the course of the ordinary activities and those that do not, consideration needs to be given to the nature of the entity and its operations,
    - BC35 of IAS 16, which explains clearly the Board's reasoning underpinning the requirements of paragraph 68 of that Standard,
    - IAS 18 *Revenue* paragraph 7, which defines revenue,
    - IAS 2 *Inventories* paragraph 6, which defines inventories,

- IAS 40 Investment Properties paragraph 58, which deals with transfers to inventories,
- IAS 1 *Presentation of Financial Statements* paragraphs 32 to 35, on offsetting.

21. The Board may also consider whether additional conditions should be met to recognise revenue gross, for instance: the business model of the entity relies on leasing and selling the assets (dual intention), a structure is in place to facilitate these sales, and an active market exists for the second-hand assets.
22. In addition, attention should be paid to the effects on the cash-flow statement to avoid initial expenditure on purchases of assets being classified as investing activities while inflows from sales are recorded within operating activities.
23. The IFRIC is asked:

- Do you agree with the staff recommendation that the relevant outcome of this project would be to amend Standards within the Annual Improvements Process?
- If yes, do you agree with the wording for rejection set out in appendix 1?
- Do you have any comment on the inconsistency between IAS 40 and IFRS 5 set out in paragraph 18 of this paper?

Appendix 1: proposed wording for rejection

[Omitted from observer notes]

Appendix 2: accounting principles of one major vehicle manufacturer

[Omitted from observer notes]

Appendix 3: the submission

[Omitted from observer notes]