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Dear Mr Stewart

Potential agenda item request

This letter describes an issue that we believe should be added to the agenda of the IFRS Interpretations Committee (IFRIC). We have included a summary of the issue, a range of possible views and an assessment of the issue against IFRIC's agenda criteria.

The issue: single-asset, single-lessee operating lease vehicles and the assessment of control under IFRS 10

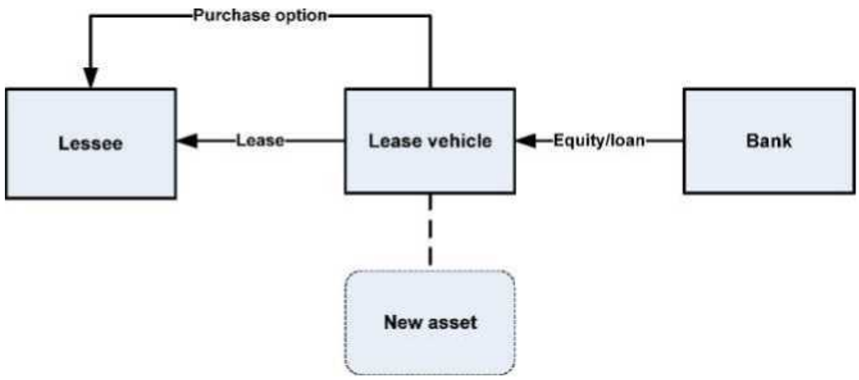
The application of IFRS 10 *Consolidated Financial Statements* to leasing vehicles can be a complex exercise. And in carrying out that exercise, we believe that the power analysis under IFRS 10.10-14, including the interaction with IAS 17 *Leases,* is unclear and is leading to diversity in practice.

The question asked in this letter is whether a lessee's decision-making rights over the use of a leased asset (i.e. 'right of use') during the lease term and / or the right to exercise a purchase option under the terms of the lease term are decision-making rights over relevant activities of a leasing vehicle. A leasing vehicle, as well as the underlying lease, can be structured in a variety of ways. However, this letter focuses on a structure that we believe highlights the lack of clarity in how to apply IFRS 10: a single-asset, single-lessee operating lease vehicle.

The following example is used to illustrate the issue:

- A lease vehicle buys an asset from a manufacturer, financed by a bank loan, and leases it to a single lessee for an agreed period under a lease that meets the criteria in IAS 17 *Leases* for operating lease classification.
- The lease provides the lessee with an option to purchase the asset at a future date.

- The bank manages the credit risk associated with the lease payments and makes decisions regarding the sale of the asset at the end of the lease term, if the lessee's purchase option is not exercised.



In practice, more commonly the vehicle would also have an equity participant. That is, there would be a company that is in the leasing business that sets up the vehicle, holds an equity position, obtains bank financing and arranges the lease with the lessee. The activities that the bank has the power to direct in this example are often activities that the equity participant has the right to direct. In that case, the bank often just makes a loan and receives protective rights that become operable in the event of a default on the loan. However, the above example (which forms the basis of the discussion that follows) has been deliberately simplified because this letter focuses on the rights of the lessee, and therefore the equity participant and financier have been collapsed into as single party: the bank.

The example also includes a purchase option in addition to the lessee's right of use. Although this additional feature is not critical to the issue raised in this letter, it has been included because it is a common feature of many lease agreements that may represent an example of decision-making rights held by the lessee.

Whether the lessee's right of use and / or purchase option are decision-making rights over the relevant activities of the vehicle can potentially result in significantly different accounting outcomes than the accounting required by IAS 17.

- If the lessee's decision-making rights are rights over relevant activities of the vehicle, both the lessee and the bank would have decision-making rights over relevant activities of the vehicle. The question that would then need to be answered is whether the lessee or the bank is able to direct the relevant activities that most significantly affect the returns of the vehicle (IFRS 10.B13). If the answer to that question is 'the lessee', and the 'returns' (IFRS 10.15-16) and 'linkage' (IFRS 10.17-18) tests are also met, the lessee would consolidate the vehicle. This conclusion would make the lease classification outcome under IAS 17 irrelevant.

- Alternatively, if the lessee's decision-making rights are not decision-making rights over relevant activities of the vehicle, the lessee will not be required or permitted to consolidate the vehicle solely because of the lease arrangement. This conclusion would preserve the lease classification outcome under IAS 17.

IFRS 10 defines relevant activities as 'activities of the investee that significantly affect the investee's returns'. While IFRS 10.B51 indicates that involvement in design is not on its own sufficient to give an investor control, IFRS 10.B5-B8 and B17 require consideration of the purpose and design of the investee to determine whether the investor has power over the investee. In this regard, IFRS 10.B8 requires the consideration of, among other things, 'the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks.'

In applying this guidance, we are aware that there are diverging views as to whether the risks that are transferred to the lessee pursuant to the lease agreement (i.e. risks and rewards incidental to ownership of the asset) should be regarded as risks to which the lease vehicle is designed to be exposed (and are passed on to the lessee).

Current practice

Although IFRS 10 only came into effect on 1 January 2013, we believe that the issue has started to establish itself as a practice issue as entities seek to finalise their accounting policies under the new standard. We believe that the IFRIC should consider the issue because the potential outcomes (consolidation versus non-consolidation) could have a significant effect on financial statements, and consistency in this area is desirable.

Here we outline what we believe are the different emerging interpretations.

View 1: Yes, the lessee's right of use and purchase option give the lessee decision-making rights over relevant activities of the vehicle

Supporters of this view believe that the lease vehicle is designed to be exposed to the risks and rewards incidental to ownership of the asset, both during and after the lease term; and the vehicle passes on the risks associated with use of the asset to the lessee via the lease agreement.

The lease vehicle's returns are significantly affected by the fair value of the asset, and the use of the asset both during and after the lease term is an activity that significantly affects the value of the asset and therefore the returns of the vehicle. Under this view, both the lessee and the bank are seen as decision makers that have the ability to direct the use of the vehicle's asset. Therefore, both the lessee and the bank have decision-making rights over relevant activities of the vehicle. During the lease term, the rights are exercised by the lessee; after the lease term, they are exercised by either the lessee or the bank, depending on whether the lessee exercises its purchase option.

That the lessee has decision-making rights over relevant activities of the vehicle is despite the fact that the lessee's right of use and purchase option are exercised outside the legal boundaries of the vehicle. This is because IFRS 10.B52 (supported by Example 11) indicates that these activities may nevertheless be regarded as closely related to the vehicle and therefore in substance an integral part of the vehicle's overall activities.

Supporters of this view observe that it is consistent with US GAAP. The FASB's Accounting Standards Codification (ASC) 810-10-55-178 states:

> *Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's [variable interest entity's] economic performance and determine whether it has the power to direct those activities. <u>The economic performance of the VIE is significantly impacted by the _ fair value of the underlying _ property</u> and the credit of the lessee. <u>The lessee's maintenance and operation of the leased _ property has a direct effect on the fair value of the underlying property,</u> and the lessee directs the remarketing of the property. The lessee also has the ability to increase the benefits it can receive and limit the losses it can suffer by the manner in which it uses the property and how it remarkets the property.* [Emphasis added]

The consequence of View 1 is that if the relevant activities over which the lessee has decision-making rights are regarded as those that *most* significantly affect the returns of the vehicle, the lessee will have power over the vehicle. If the 'returns' and 'linkage' tests in IFRS 10 are also met, the lessee will consolidate the vehicle, even when the lease is classified as an operating lease under IAS 17.

View 2: No, the lessee's right of use and purchase option do not give the lessee decision-making rights over relevant activities of the vehicle

Supporters of this view argue that View 1 does not take into account the economics of setting up a lease vehicle. They observe that lease vehicles are typically created only after a lessee is identified and the lease agreement creates the risk to which the vehicle is designed to be exposed. Accordingly, they believe that the lease vehicle is designed to be exposed to the credit risk of the lessee and the residual value risk associated with the asset only if the lessee does not exercise the purchase option.

Decision-making rights over the relevant activities that correspond to these risks are the management of lease receivables in default and the management of residual value. The management of residual value includes monitoring the lessee's right of use and, if the lessee does not exercise the purchase option, the sale of the asset. The lessee does not have decision-making rights over these activities.

Supporters of this view acknowledge that the lessee's right of use affects the residual value of the asset. However, instead of regarding the lessee as a party with decision-making rights over the relevant activities of the vehicle, they see the consequences of the lessee's right of use on the residual value of the asset as a risk to which the vehicle was designed to be exposed, similar to other risks that impact the residual value of the asset (such as obsolescence risk). Therefore, the activity of the vehicle that is relevant for the IFRS 10 analysis is the monitoring of the lessee's right of use, in response to the risk that the lessee may exercise its right 'improperly'.

The above is consistent with the fact that the lease agreement typically contains safeguards against the lessee's potential abuse of the right of use (e.g. maintenance obligations of the lessee). This view is also consistent with the observation that the lessee's credit risk cannot be regarded as negligible in all cases and that the decisions to be made if the lessee defaults can significantly affect the vehicle's returns (although generally the risks associated with the residual value are likely to be more significant).

Similarly, the lessee's purchase option does not give the lessee decision-making rights over relevant activities of the vehicle, consistent with the view that the vehicle is designed to be exposed to the consequences of the actions taken by the lessee. In the context of a purchase option, relevant activities in relation to the management of the residual value occur only when the lessee decides not to exercise its purchase option, as in IFRS 10.B53. This contrasts with the case in which the lessee does not have a purchase option, in which case the bank has to decide on the sale of the asset at the end of the lease term in all circumstances.

Notwithstanding the US GAAP guidance cited under View 1, supporters of this view note that US GAAP (ASC 810-10-55-39) stipulates that an operating lease is not considered a 'variable interest' in a lessor entity (lease vehicle) if the lease contains only 'plain vanilla' terms (i.e. no off-market purchase or renewal options, or residual value guarantees):

> *Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset's life that is covered by the lease. Most operating leases do not absorb variability in the fair value of a VIE's net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions described in paragraphs 810-10-25-55 through 25-56. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 810-10-25-57. The guidance in paragraphs 810-10-55-23 through 55-24 related to debt instruments applies to creditors of lessor entities.*

Although this requirement is inconsistent with the general guidance on variable interests in ASC 810-10-55-16 through 55-32 (including the guidance on forward contracts and total return swaps in ASC paragraphs 810-10-55-28 and 55-30), for basic leasing structures it means that a lessee is not required to evaluate whether it has decision-making rights over the relevant activities of the vehicle unless the lessee has another variable interest (e.g. an equity interest in the vehicle). Accordingly, in those situations application of the US GAAP approach would mean that the lessee may not be required or permitted to consolidate the vehicle solely as a result of entering into a plain vanilla operating lease.

The consequence of View 2 is that the lessee would not generally have decision-making rights over the relevant activities of the vehicle. Accordingly, the lessee is unlikely to be able to direct the relevant activities that most significantly affect the returns of the vehicle and therefore will not consolidate the vehicle, resulting in more consistent outcomes between IFRS 10 and IAS 17.

Assessment against agenda criteria

a) ***Is the issue widespread and practical?*** Yes. Single-asset, single-lessee operating lease vehicles are common, and we expect this issue to be widespread.

b) ***Does the issue involve significantly divergent interpretations?*** Yes. Depending on the interpretation applied, the decision to consolidate versus not consolidate could have a pervasive and significant effect on the financial statements of the lessee and other parties that are involved with a single-asset, single-lessee operating lease vehicle.

c) ***Would financial reporting be improved through elimination of the diversity?*** Yes. The comparability of financial statements will be improved if entities assess the lessee's decision-making rights on the same basis in assessing who has power over a single-asset, single-lessee operating lease vehicle.

d) ***Is the issue sufficiently narrow...?*** Yes. We believe that the issue is capable of interpretation within the confines of IFRS 10. It is concerned with specific concepts in IFRS 10.

e) ***If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*** The issue does not relate to a current or planned IASB project.