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Subject: Submission of potential IFRIC Agenda Item concerning the consolidation of single-asset SPVs under IFRS 10

Dear Madam or Sir,

As a leading manufacturer of high-priced products, we are also in the business of providing financing to our customer base. Our customer financing activities often involve the creation of special purpose vehicles ('SPVs') that act as lessors to the customer in need of financing. In an SPV lease structure, our financial services arm and other investors (unrelated to the group) provide loans of different seniority to the SPV that then uses the loan proceeds to buy our product and lease it to our customer under an operating or finance lease.

IFRS 10 does not specifically address the consolidation of single-asset lease entities, and applying the principles set down in the standard to certain of our finance lease vehicles has given rise to two contradictory views – presented in more detail as View A and View B below – of when and by whom such structures should be consolidated. We therefore would like to submit the issue of consolidating single-asset lease entities to the IFRS Interpretations Committee for clarification.

More particularly, the issue we would like to refer to the Interpretations Committee is whether in a finance lease structure the asset repossession rights a lender has in case of customer-lessee default would constitute control or be considered protective only. We think that an assessment of whether such rights constitute control will partly depend on whether the consolidation of such finance lease structures would have to be assessed based on paragraph IFRS 10.B28 (b) or paragraph 10.B53. It may also depend on whether the lessee's ability to use the leased asset and its being exposed to the asset's residual value risk would be considered factors that are relevant to the IFRS 10 control assessment.

As an illustration of the difficulties we had in assessing control for such single-asset SPVs, suppose one such SPV is financed by a senior loan of 45 and a junior loan of 15. The SPV's foundation documents provide for the SPV to use the total proceeds of 60 to acquire our product and lease it for 12 years to a customer that (1) has already made an advance payment of 20 for that product to us (as the manufacturer) and (2) may acquire the product after 12 years for $1. The lenders will be fully repaid by the lease payments during the 12 year lease-term. In case of a customer-lessee default, the senior lender has the right to sell, or direct the sale of, the leased asset and use the sales proceeds to recover any outstanding principal and interest. If the sales proceeds exceed the amount of outstanding principal and interest, the excess goes to the junior lender, and once the junior lender is paid off as well, to the customer-lessee. In order to address a situation in which a senior lender may be tempted to accept a below-market price because the below-market proceeds are sufficient to provide a full pay-off of the senior lender's outstanding balance, the junior lender has a (post-default) 'buy-out' right under which it is entitled (but not obliged) to repossess the asset by paying the senior lender an amount equal to the senior lender's outstanding principal and interest balance.

When assessing such an SPV for consolidation, **View A** would consider IFRS 10.B53 to be applicable and conclude that the junior lender should consolidate the SPV. IFRS 10.B53 addresses situations where the only return-affecting decisions about an investee's activities are to be made when particular circumstances arise or events occur and clarifies that these "circumstances and events need not have occurred for an investor with the ability to make those decisions to have power". A case in point is provided in Example 11, where an SPV is created whose only business activity is to purchase receivables and service them on a day-to-day basis. The SPV's founding documents provide that any receivable that defaults is to be sold to an investor immediately. The example clarifies that "the only relevant activity is managing the receivables upon default because it is the only activity that can significantly affect the investee's returns" and that "the design of the [SPV] ensures that the investor has decision-making authority over the activities that significantly affect the [SPV's] returns at the only time that such decision-making authority is required". The example concludes that the sale of defaulted receivables to the investor together with the SPV's founding documents "leads to the conclusion that the investor has power over the investee even though the investor takes ownership only upon default and manages the defaulted receivables outside the [SPV's] legal boundaries".

Applied to the asset-financing SPV described above, paragraph 10.B53, and Example 11 therein, would seem to require – according to View A – that the junior lender consolidates because it has the ability (via its buy-out rights) to direct the asset sale upon a loan event of default (as the SPE's only activity that can significantly affect the lenders' returns) and at the same time is exposed, or has rights, to the variable returns to be derived from the SPE in the form of proceeds from the asset sale. (In contrast, the senior lender may be prevented from directing the asset sale activities by the junior lender, so does not consolidate.)

View B, however, would disagree, for various reasons:

- It is doubtful whether 10.B53 is meant to apply to single-asset finance lease structures. After all, there are at least two significant differences between the SPV in Example 11 and the asset-financing SPV above:
    - (i) The set-up in Example 11 implies that all parties involved expect *some* receivables to default, so that the controlling party is virtually certain to exercise its ability of directing the relevant activity of managing defaulted receivables at some point. In contrast, the junior lender will usually not exercise its buy-out right, nor ever have the practical ability to do so throughout the SPV's life unless the customer-lessee defaults (which at

inception of the SPV is not expected to be the case, otherwise the SPV would not be set up.)

(ii) The controlling entity in Example 11 is entitled to a return whose variability is determined by the number of defaulting receivables and the amount of loss incurred on each, and may not be expressed in terms of proceeds from principal plus interest thereon. In contrast, the junior lender to the single-asset SPV is entitled to receive principal plus interest thereon, ie receive a 'lender's return' and nothing else. For instance, it never has the right to a return exceeding the amount of principal plus interest (but would have to transfer any such excess to the customer-lessee).

- Unlike 10.B53, paragraph 10.B28, when referring to "the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions", specifically addresses the rights exercisable by the junior lender, which rights, based on the guidance provided by 10.B28, would then have to be considered protective.
- It is unclear why a lender's asset repossession rights should be deemed protective (under 10.B28) when a loan is directly provided to a customer (in which case there should be no doubt that 10.B28 is applicable), but considered an instance of control when the loan is channelled through an finance lease SPV as outlined above (on the assumption that in the context of such an SPV asset repossession upon lessee default is the *only* activity that can affect the SPV's returns and so must be a relevant activity).
- On account of the SPV being designed to provide financing to the customer and the finance lease transaction being economically equivalent to the customer's purchase of an asset that is partly financed by loans, View B would consider consolidation by the customer-lessee to be appropriate as it reflects the economic substance of the transaction. However, in terms of IFRS 10, consolidation by the lessee appears only to be achievable, if (a) the variable returns derived by the customer-lessee from its right-of-use of the asset and its residual value would be considered returns derived from the customer-lessee's involvement with the SPV and (b) directing both the use and the potential post-lease sale of the leased asset would be considered relevant activities of the SPV itself. It is unclear whether this would be the case under IFRS 10.
- Requiring the junior lender to consolidate finance lease structures such as the SPV described in our example may give rise to economically similar transactions being accounted for differently. For instance, an alternative, but economically identical, SPV set-up may provide for the 20 advance payment to be contributed to the SPV, rather than paid directly to the manufacturer. The customer would thus become an investor in the SPV. The SPV would then buy the product for 80 rather than 60 but otherwise lease the product to the customer-lessee under the same terms (excluding only the $1 bargain purchase option). At the end of the 12 year lease, the leased asset would be returned to the SPV (at its end-of-lease value which is initially expected to be 20), and the customer as the only remaining investor would then have to decide whether to sell, or re-lease the asset, or continue to use it. Under such a set-up, the relevant activities of the SPV would comprise managing the leased asset upon lessee default and managing the leased asset upon its end-of-lease return. Very likely (the lessee not being expected to default), the latter activity will be considered the one that most significantly affects the SPV's returns, and hence the customer as the investor with the ability to direct that activity (rather than the junior lender) be the party that consolidates the SPV under IFRS 10 (given that the customer is also exposed to the SPE's variable returns). View B proponents argue that a mere structuring device such as channelling a cash flow through an SPV rather than making a direct payment should not produce a different outcome as to which party controls and hence consolidates an SPV.

- As another variant to our base scenario, consider an SPV set-up that is closely modelled on Case G in ASC 810-10-55: As in our base scenario, an SPV that is financed by a senior loan of 45 and a junior loan of 15 uses the proceeds of 60 to acquire a product and enter into a 12 year lease with a customer-lessee. However, the SPV will only receive lease payments of 40 plus interest over the lease term (instead of 60 plus interest implied by the base scenario). At the end of the lease term the customer-lessee has the option to acquire the asset at its expected future value of 20 (in which case the total 'principal' payments made by the lessee amount to 60 which equal the 60 principal payments made in the base scenario). If the customer-lessee does not exercise the purchase option, it will have to (i) remarket the asset on behalf of the SPV and (ii) compensate the SPV for any excess of the expected future asset value of 20 over the sales proceeds. If, on the other hand, the sales proceeds exceed 20, the customer-lessee may keep the excess amount. Under US GAAP, ASC 810-10-55-178 clarifies that the economic performance of such an SPV is significantly impacted by the fair value of the underlying asset and the credit of the lessee; and ASC 810-10-55-181 concludes that the lessee would have to consolidate the SPV because (a) it is the interest-holder with the power to direct the activities that most significantly impact the SPV's economic performance and (b) it has the obligation to absorb losses of the SPV and the right to receive benefits from the SPV. View B proponents would hold that under IFRS 10 consideration of (a) and (b) above would likewise result in the customer-lessee being identified as the party that consolidates the SPV; and they would argue that, the Case G variant and the base scenario being economically equivalent, it is not appropriate to construe IFRS 10 as to require consolidation by the junior lender in the base scenario.

We think that the IFRS Interpretations Committee should address the issue of whether in a finance lease structure the asset repossession rights of a junior lender in case of lessee default would constitute control (as opposed to being protective rights only) because:

- We expect the issue to be widespread considering that (i) the underlying assets of single-asset lease SPVs may consist of various products such as aircraft, ships, buildings or equipment and (ii) the FASB deemed the issue of consolidating single-asset SPVs to be sufficiently important to warrant a separate discussion under US GAAP.
- Clarifying the IFRS 10 consolidation principle for finance leases undertaken by single-asset SPVs would improve financial reporting by eliminating potential diversity of interpretation and increasing comparability.
- We think the issue can be resolved within the confines of IFRS 10.
- The issue, being confined to finance leases undertaken by single-asset SPVs, is sufficiently narrow to be addressed in an efficient manner but not so narrow that its being investigated by the Interpretations Committee would not be cost-effective.
- A solution developed by the Interpretations Committee may be expected to be effective for a reasonable time period as, to our knowledge, the issue is not being addressed in any forthcoming standard or amendment.

If you wish us to provide additional input, or if you would like to discuss with us any of the points raised above, we would be pleased to do so.