

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IFRS 10 <i>Consolidated Financial Statements</i>		
Paper topic	Control of a structured entity by a lender		
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Purpose of this paper

1. The IFRS Interpretations Committee (‘the Interpretations Committee’) has received a request for clarification about IFRS 10 *Consolidated Financial Statements*. In the submitter’s example, a structured entity (‘SE’), financed by a number of lenders, is created to lease a single asset to a single lessee. The submitter asks whether the junior lender should consolidate the SE. The submitter asks whether the lender’s right to control the disposal of the leased asset on default is a protective right, which does not give the lender power over the SE, or a decision-making right over the relevant activity of the SE, which does give the lender power over the SE.

Paper structure

2. This paper is organised as follows:

- (a) submission received;
- (b) requirements of IFRS 10;
- (c) accounting methodologies for the transaction identified in the submission;
- (d) summary of outreach conducted;
- (e) staff analysis;
- (f) submitter's Case B;
- (g) staff summary;
- (h) assessment against our agenda criteria;
- (i) staff recommendation;
- (j) Appendix A—Draft agenda decisions; and
- (k) Appendix B—original submission.

Submission received

3. The submission contains two similar cases that differ only with respect to whether the lessee makes its initial payment to the manufacturer or the SE. We will consider Case A first and then we will consider Case B.

Case A

4. A manufacturer sells high value, technologically-advanced plant and equipment. A structured entity is created on behalf of the manufacturer and its customer. The

SE holds a single asset made by the manufacturer, which is subsequently leased to the customer under a finance lease.

5. The cost of the asset is 80CU. The customer pays 25 per cent of the consideration directly to the manufacturer. The remaining 75 per cent of the asset is sold to the SE, which is itself financed by both senior and junior lenders. The customer enters into a finance lease with the SE for the remaining 75 per cent interest in the leased asset:

Lease financing 75%	CU
Lease payments-principal	60
Lease payments- interest	25
Total payments	85
Residual value of asset	20

6. At the end of the lease period, the lessee can acquire the asset for CU 1.
7. If the lessee/customer defaults, the senior lender has the right to repossess the leased asset and resell it. In the event of default, the senior lender is repaid before the junior lender. Amounts received from selling the asset in excess of the sums due to the senior and junior lenders go to the lessee.
8. In order to protect the junior lender from a resale by the senior lender at a reduced price, the junior lender has a right to buy the asset from the senior lender at an amount equal to the principal and interest due to the senior lender. The junior lender can then sell the asset in order to recoup as much of its unpaid principal and interest as possible.
9. The submitter asks whether the junior lender should consolidate the SE.

10. The full submission is included as Appendix B.

Requirements of IFRS 10

11. IFRS 10 requires an entity that is a parent to present consolidated financial statements. The Standard also sets out the accounting requirements for the preparation of consolidated financial statements.
12. There is a single principle as the basis of preparing consolidated financial statements, which is that of a parent's control over the investee. This principle is stated in the Standard:

5 An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.

6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

7 Thus, an investor controls an investee if and only if the investor has all the following:

- (a) power over the investee (see paragraphs 10–14);
 - (b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16)
- and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

13. The submitter's query arises from one aspect of control—power.

14. Paragraph 10 of the Standard defines power:

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee's returns.

Accounting methodologies for the transaction identified in the submission

15. The submitter identifies two methodologies for accounting for this transaction based on who directs the relevant activities of the SE:

- (a) View A—the junior lender consolidates the SE; or
- (b) View B—the junior lender does not consolidate the SE.

View A—the junior lender consolidates the SE

16. Supporters of this view refer to paragraph B53 of IFRS 10 which considers the case of an entity that has no relevant activity other than managing receivables on default. By analogy, supporters of this view think that managing the sale of the leased asset on default is the relevant activity of the SE and, consequently, the junior lender has power over the SE. Because the junior lender has power over the SE and derives returns from the SE, supporters of this view think that the junior lender controls the SE.

View B—the junior lender does not consolidate the SE

17. The submission, on page two, distinguishes the SE from the entity in Example 11 in B53:
- (i) The set-up in Example 11 implies that all parties involved expect *some* receivables to default.. . In contrast the junior lender will usually not exercise its buy-out right.... .
 - (ii) The controlling entity in Example 11 is entitled to a return whose variability is determined by the number of defaulting receivables.. . In contrast the junior lender is entitled to receive principal plus interest thereon, ie receive a lender's return, and nothing else.
18. Supporters of this view think that the junior lender's right to buy the asset is a protective right typical of any secured loan which, in accordance with the definition of protective rights in IFRS 10, does not give power over the SE to the junior lender.

Summary of outreach conducted

19. IFRS 10 was effective from January 2013, although not mandatory in Europe until January 2014. We conducted our outreach on this submission together with the outreach on the submission that is the subject of Agenda Paper 12 A.
20. We contacted two regulatory bodies, members of the International Forum of Accounting Standard-Setters (IFASS) and a number of accounting firms. Outreach participants were asked to indicate:
- (a) Whether they were aware of any transactions of this type that take place in their jurisdiction. If yes,

- (i) How common is this type of transaction?
- (ii) How is the structured entity accounted for in their jurisdiction, ie which entity would consolidate the SE in each case?
- (b) Is there diversity in practice?
- (c) If they have a preferred or recommended treatment, what is it and why?

Analysis of respondents

21. We received fourteen responses to our outreach request:

Nature of respondent	Number
Standard-setters	8
Accounting firms	5
Regulator bodies	1
Total	14

Geographical location of respondent	Number
Africa	1
Asia and Oceania	4
Europe	4
Global	5
Latin America	-
North America	-
Total	14

Comments received in outreach

22. Four respondents were not aware of any transactions of this type in their jurisdiction and expressed no preference for the accounting treatment.
23. The remaining respondents thought these transactions were much less common than the arrangements that are considered in Agenda Paper 12A, although few respondents reported knowledge of any specific transactions. Their general view is:
- (a) A decision about control would need to be made based on a careful analysis of the facts and on a case-by-case basis.
 - (b) The fact pattern submitted was very complex and the submitter provided insufficient information to make that analysis. Most

respondents say that in the absence of this information, it is difficult to say whether the SE should be consolidated or what their preferred treatment would be.

- (c) The principles of IFRS 10 are sufficiently clear to enable that assessment to be made when all the relevant facts are available.
- (d) Some respondents thought that the junior lender's rights over the leased asset were protective rights that did not confer power.
- (e) Only three respondents expressed a preferred treatment. One respondent made points in support of View A, but View B was preferred by the other two. All comments were conditional upon a number of unresolved queries about the fact pattern.

Staff analysis

24. In analysing this issue we think that there are three aspects of the fact pattern to consider in more detail:
- (a) an assessment of the relevant activities of the SE;
 - (b) the junior lender's right to sell the asset; and
 - (c) satisfying the other requirements of control.

An assessment of the relevant activities of the SE

25. Relevant activities are defined as those activities that significantly affect the investee's returns. The returns of the SE could potentially be affected by:
- (a) the management of the lease receivables;

- (b) the management of the sale or re-lease of the leased asset at the end of the lease period; and
- (c) the management of the sale or re-lease of the leased asset on default.

26. In order to identify the relevant activity when there is more than one potential relevant activity, we need to identify which of the three has the greatest effect on the returns of the SE. There are a number of factors that can affect these returns:

- (a) If the credit risk of the lessee is high, management of the lease receivable or the management of the sale or re-lease of the leased asset on default are the activities that could most significantly affect the returns of the SE.
- (b) If the lease term is short in relation to the useful life of the asset, management of the sale or re-lease of the asset at the end of the lease term may significantly affect the returns of the SE. (We note, however, that a finance lease would normally be for the major part of the economic life of the asset.)
- (c) The effect on the returns of the SE of the sale or re-lease of the asset at the end of the lease will depend on whether the lessee exercises its option to purchase the asset. We notice that in accordance with the terms of the finance lease, the lessee can buy an asset with a residual value estimated to be CU 20 for CU 1, ie a bargain price.
- (d) The effect of the sale or re-lease by the junior lender, in the case of default, on the returns of the SE is not clear. The junior lender has a buy-out right to recover as much of its owed principal and interest as possible. The excess proceeds accrue to the lessee (page 3 of the submission.) Consequently, we are not clear how the disposal of the

asset by the junior lender in default affects the returns of the SE. We do not know what the arrangements are if the proceeds from the sale of the asset are not sufficient to reimburse the senior and junior lenders in full.

27. In order to identify the relevant activities of the SE we need more information about the design of the lease, the useful life of the asset, the credit risk of the lessee and the effect of the sale of the asset in case of default on the returns of the SE.

The junior lender’s right to sell the asset

28. Supporters of View A think that the right to sell the asset on default is the activity that most significantly affects the returns of the SE. They think that all other returns are predetermined by the terms of the finance lease.
29. They quote paragraph B53 of the Standard in support of this view. That paragraph deals with situations in which the only return-affecting decisions are to be made when particular circumstances arise. The entity is designed so that the direction of its activity and its returns are predetermined unless and until those particular circumstances occur.
30. In accordance with this view, management of the credit risk of the lease receivables, and management of the disposal of the leased asset at the end of the lease, are not relevant activities because:
- (a) they do not affect the returns of the SE other than in the way predetermined by the lease; or
 - (b) they have less effect on the returns of the SE than the right to sell on default.

31. Supporters of View A think that the right to sell on default gives power to the junior lender even before default occurs. Paragraph B53 also notes that ‘circumstances and events need not have occurred for an investor with the ability to make those decisions to have power’.
32. View B in the submission is based on the converse view.
33. In accordance with View B, as expressed in the submission, management of the credit risk of the lease receivables and management of the disposal of the leased asset at the end of the lease are the SE’s relevant activities because the SE is not designed to have management of the asset in default as its relevant activity. This argument is based on there being no *expectation* that the lessee will default and, consequently, by design, the activity triggered by default is not a relevant activity. Similarly, the submission explains View B in terms of the junior lender having no right to variable returns in the normal course of business. The View B expressed in the submission thinks that Example 11 is B53, by contrast, is based on the expectation of default.
34. We think that in both Example 11 and Example 12 in paragraph B53 ‘expectation’ is not the basis of an assessment of power in accordance with IFRS 10. We think that in these examples, control is based on the *ability* to direct the relevant activities rather than the *expectation* to do so. Consequently, we think that basing an assessment of power on the expectation or otherwise of default is at odds in those cases with IFRS 10. We note, however, that when there is more than one activity that can significantly affect the returns of an investee, expectations can play a part in determining which of those activities most significantly affect the entity’s returns and, consequently, expectations can play a part in determining power in those circumstances.

Protective rights

35. Supporters of View B think that the junior lender's rights are protective rights. Protective rights are defined in IFRS 10 as rights that do not give the entity power over the investee.
36. The Standard gives some common examples of protective rights:
- B28
- (b) . . .
- (c) the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

Satisfying the other requirements of control in IFRS 10

37. The submitter does not address all components of control in their discussion of Views A and B. In addition to power, IFRS 10 paragraph 7 also requires:
- (b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16) and
- (c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).
38. On the basis of the limited facts provided, we think that the junior lender has exposure to variable returns from its involvement with the SE, although only in the case of default. The junior lender's returns are agreed with the SE at inception

of the lease. Those returns are known and there is no variability unless default occurs. If default occurs, the junior lender's returns (ie repayment of principal and interest) may be affected, if the sale of the asset is less than the principal and interest due to the junior lender after deducting the amounts due to the senior lender. Any excess sales proceeds are transferred to the lessee.

Summary

39. We note that the submitter does not request clarification of the requirements of IFRS 10. Instead the submitter is asking about the judgement to be made in applying the Standard to the specific fact pattern laid out in Case A.

Submitter's Case B

40. The facts are the same as those outlined in paragraphs 3-6 except that the customer/lessee does not pay 25 per cent of the consideration directly to the manufacturer. Instead, it pays 25 per cent to the SE itself. During the course of the lease, both senior and junior lenders are repaid. The lessee is not repaid.
41. In Case B, the submitter thinks that both the sale of the asset on default, and the sale of the asset at the end of the lease, are considered to be the relevant activities of the SE. The junior lender controls the sales activities on lessee default and the customer/lessee controls the sales activities at the end of the lease.
42. The submitter thinks that because the asset's residual value at the end of the lease is significant, selling the asset (or continuing to use it) at the end of the lease may prove to be the more relevant activity. In that case, the most relevant activities of the SE are controlled by the customer/lessee and consequently the lessee has

power over the SE. Supporters of this view think that the lessee would consolidate the SE, not the junior lender.

43. The submitter notes that the way in which the asset is financed through a lease is identical in each case, but the way in which the SE itself is financed differs:

Case A			Case B	
Leased asset	60		Leased asset	80
Senior loan	(45)		Senior loan	(45)
Junior loan	(15)		Junior loan	(15)
			Lessee contribution	(20)

44. The submitter thinks that the original example, Case A, and Case B are similar economically and is concerned that if View A were the accepted view in Case A, the consolidation decision in Case B, which would be made in accordance with IFRS 10, would be different.
45. Two respondents to outreach specifically referred to Case B and concluded that the difference in fact patterns presented might affect the extent to which different activities could affect the returns of the SE and, consequently, this might result in different control conclusions. Both respondents thought the different conclusions reflect the different economics of the two cases.
46. A third respondent did not understand why the sale of the asset at the end of the lease is considered by the submitter to be a relevant activity in Case B but is not considered to be a relevant activity in Case A, as analysed in the submission. We agree with this comment.

Staff summary

47. We are not sure of the mechanism of the payment of CU 20 by the lessee in Case B and it is not clear how payment of CU 20 to the manufacturer (Case A) results in a different statement of financial position to that recognised when payment is made directly to the SE (Case B). (Based on the limited information available, we think that in case A the SE would have a lease receivable of CU60. In Case B it would have an initial lease receivable of CU 80 which is reduced by an initial payment by the lessee of CU 20 to give a lease receivable of CU 60, ie equal to that in Case A.) Accordingly, on the basis of the limited information available, after that initial payment is made the by lessee, there would appear to be little difference between Case A and Case B.
48. In the staff view, we do not have sufficient information in the example in Case B to distinguish Case A from Case B or to determine which entity controls the SE.

Staff summary

49. In making an assessment of which entity controls another in accordance with IFRS 10, it is necessary to make a careful assessment of the facts and circumstances in order to identify the relevant activities of the entity.

Case A

50. View A is based on a view that the management of the credit risk of receivables and the disposal of the asset at the end of the lease has less effect on the returns of the SE than the disposal of the asset on default. Consequently, the disposal of the asset on default is the relevant activity of the SE.

51. View B is based on a view that the relevant activities are the management of the lease receivables and the disposal of the asset at the end of the lease period, and that the lease has been designed with those risks in mind.
52. We do not think that we have sufficient information about aspects of the transaction to reach a conclusion about whether the lender does or does not control the SE. More information is required on, for example:
- (a) the purpose and design of the SE;
 - (b) the credit risk of the lessee;
 - (c) who benefits from the disposal of the leased asset at the end of the lease if the lessee does not exercise its purchase option; and
 - (d) how the disposal of the asset by the junior lender on default affects the results of the SE.
53. We also note that in order to make an assessment about who controls the SE, we would also need information about the rights of other parties. In particular, we would require more information about the rights of the lessee.
54. We do think, however, that the principles established within IFRS 10 would allow the assessment of control to be completed when all required information is known.

Case B

55. The submitter is troubled by the possibility that the application of IFRS 10 to the fact patterns in Case A could result in a different consolidation conclusion from that in Case B. On the basis of the limited information available, we do not think this would be the case. Nonetheless, we do not think that we have sufficient

information about the fact pattern to assess which entity should control the SE or to distinguish the financing of the SE in Case A or Case B.

Assessment against our agenda criteria

56. We have assessed this issue against the agenda criteria of the current *Due Process Handbook*:

Paragraph 5.16 states that we should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	No. Although the consolidation decision could have a material effect on those affected, we have no evidence that this type of transaction occurs frequently.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	No. We are not aware of any evidence of diversity in practice.
that can be resolved efficiently within the confines of existing IFRSs and the <i>Conceptual Framework for Financial Reporting</i> .	Yes. It could be resolved within those confines.
In addition:	

Paragraph 5.16 states that we should address issues:	Agenda criteria satisfied?
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	No This submission is about the application of IFRS 10 to fact-specific transaction. Resolution would require a significant amount of analysis of the rights of both the senior and junior lender, the manufacturer and the lessee.
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Yes. We are not aware of any current IASB projects that would affect this topic.

Staff recommendation

57. We do not think that we have sufficient information about the rights of the parties involved with the SE (ie the lenders and lessee) to come to a conclusion about control in these two cases. We do think, however, that the principles established within IFRS 10 would allow the assessment of control to be completed when all required information is known.
58. We note that the submitter does not ask for clarification about the wording of the Standard or suggest that the requirements of the Standard conflict with other requirements of IFRS. Instead, the submitter requests help in applying judgement to the individual facts and circumstances of the example. We note that it is not our practice to give case-by-case advice on individual fact patterns.

59. We also note that we have not received any evidence that there will be significant future diversity in practice.
60. Consequently, we recommend that the Interpretations Committee should not take this issue onto its agenda.

Question for the Interpretations Committee

Does the Interpretations Committee:

- (a) agree with the staff's recommendation that this issue should not be addressed; and
- (b) have any suggestions on the wording of the agenda rejection notice included as Appendix A?

Appendix A Draft agenda rejection notice

IFRS 10 *Consolidated Financial Statements*—Control of a structured entity by a lender

The Interpretations Committee received a request for it to consider a fact pattern related to assessing whether a particular party controls a structured entity ('the SE') that is created, financed by a senior and a junior lender, to lease a single asset to a single lessee. The submitter asks whether the junior lender controls the SE and whether the lender should consolidate the SE. The lease is a finance lease as defined by IAS 17.

The Interpretations Committee discussed this issue. It noted that it had not received any evidence that the issue was widespread nor that there was diversity in practice. It also noted that the submitter was seeking assistance in applying judgement to a particular fact pattern and that it is not our practice to give case-by-case advice on individual fact patterns.

Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.