STAFF PAPER

November 2014

IFRS Interpretations Committee Meeting

Project	**IFRS 10 *Consolidated Financial Statements* and IAS 17 *Leases***
Paper topic	Control of a structured entity by an operating lessee

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Purpose of this paper

1. The IFRS Interpretations Committee ('the Interpretations Committee') has received a request for clarification about the interaction of IFRS 10 *Consolidated Financial Statements* and IAS 17 *Leases*. In the submitter's example, a structured entity ('the SE') is created to lease a single asset to a single lessee. The submitter asks whether the lessee controls the SE and whether the lessee should consolidate the SE.

2. The consolidation decision would be based on an assessment of which entity has power over the relevant activities of the SE. The submitter asks whether a lessee's decision-making rights over the use of the leased asset, and its right to exercise a purchase option under the terms of the lease, are decision-making rights over the relevant activity of the leasing vehicle.

Paper structure

3. 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) assessment against our agenda criteria;

    (g) staff recommendation;

    (h) Appendix A: draft agenda rejection notice; and

    (i) Appendix B: original submission.

Submission received

4. A structured entity ('the SE') is created on behalf of a manufacturer. The SE holds a single asset manufactured by the manufacturer, which is subsequently leased to a single customer, the lessee. The lease to the customer is an operating lease within the terms of IAS 17.

5. The SE is financed by a third party lender, a bank. The bank manages the credit risk on the lease receipts and makes decisions about the sale of the residual asset if the lessee does not exercise its option to purchase. The bank also holds the equity in the SE.

6. The submitter thinks that there are two views in practice with respect to whether the following are the relevant activities of the SE:

   (a) use of the asset by the lessee during the lease term; and

   (b) the option to purchase the asset at the end of the lease term.

7. If the lessee's decision-making rights over the use of the asset represent rights over the relevant activity of the SE, and the returns and linkage tests of control are also met, the lessee would consolidate the SE. The lessee would, consequently, recognise the leased asset in its consolidated statement of financial position. If those rights are not decision-making rights over the relevant activity of the SE, the lessee would not control the SE and would account for the transaction as an operating lease in accordance with IAS 17. In that case, the lessee would not recognise the leased asset in its statement of financial position.

8. The full submission is included as Appendix B to this Agenda Paper.

Requirements of IFRS 10

9. 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.

10. 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).

11. The submitter's query focuses on one aspect of control—power.

12. 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.

13. The submitter's discussion focuses on identifying the relevant activities of the SE, and assessing who directs those activities, in order to identify whether the lessee controls the SE.

Accounting methodologies for the transaction identified in the submission

14. The submitter identifies two outcomes to this assessment of who directs the relevant activities of the SE:

    (a) View A—the operating lessee directs the relevant activities of the SPE; or

    (b) View B—the operating lessee does not direct the relevant activities of the SE.

View A—the operating lessee directs the relevant activities of the SE

15. This view is based on the premise that the SE, as legal owner of the asset, is exposed to the risks and rewards incidental to owning the asset.

16. In accordance with that view, the most significant factor that will affect the returns of the SE is the fair value of the leased asset at the end of the lease period. Consequently, any activity that affects that fair value is the relevant activity of the SE for the purposes of a consolidation decision made in accordance with IFRS 10.

17. Supporters of View A think that the lessee can significantly affect the fair value of the leased asset, because it has use of the asset during the lease period, and that usage will significantly affect the asset's residual value. In accordance with View A, use of the asset and the exercise of the purchase option are the most relevant activities of the SE and, consequently, the lessee would consolidate the SE. Because the lessee consolidates the lessor (the SE), the IAS 17 classification is not relevant.

18. The submitter also quotes US GAAP about variable interest entities (VIEs) (an extract from Topic 810 *Consolidation* in the *FASB Accounting Standards Codification*®):

> 810-10-55-178 The economic performance of the VIE is significantly impacted by the fair value of the underlying property…. The lessee's maintenance and operation of the leased property has a direct effect on the fair value of the underlying property.

19. View A is based on the relevant activities of the SE being the actions of the lessee that affect the value of the asset. The submitter notes that these activities are performed by the lessee, and not by the investee, the SE. The submitter is not concerned that the lessee's right of use and purchase option, ie the SE's relevant activities, are exercised outside the legal boundaries of the SE, referring to example 11 in paragraph B53 of the Standard. The submitter thinks that these activities are in substance an integral part of the SE's overall activities and, when considering View A, could be viewed as the relevant activities of the SE itself.

Summary

20. View A is based on the returns of the SE being most significantly affected by the fair value of the asset and, in accordance with this view, the entity that controls the activities that affect the fair value of the leased asset controls the relevant activity of the SE. The lessee would consolidate the SE and, consequently, the leased asset.

View B—the operating lessee does not direct the relevant activities of the SE

21. This view is based on the premise that the lease agreement creates the risks that the SE is designed to be exposed to, ie credit risk of the lessee and residual value risk.

22. These risks are managed by the SE or the bank through its actions in monitoring default, monitoring the use of the asset and managing the sale or re-lease of the asset in the event the purchase option is not exercised by the lessee. Under this

view, use of the asset is not a relevant activity. Consequently, the lessee would not consolidate the SE and its accounting for the transaction would be determined by reference to IAS 17.

23. Proponents of View B argue that financial reporting needs to take into account the economics, and purpose and design, of setting up the SE. These vehicles are typically created after the asset and lessee are identified and the lease is designed so that, during the term of the lease, the SE is only exposed to the credit risk of the lessee. It is exposed to the residual value risk only if the lessee does not exercise the purchase option. The relevant activities of the SE, therefore, are the management of lease receivables in default and the management of the residual value. Management of the residual value includes monitoring the lessee's right of use and, if the purchase option is not exercised, the sale or re-lease of the asset.

24. Supporters of View B acknowledge that the lessee's use of the asset could affect the residual value of the asset, but argue that the lease was designed with those risks in mind and will normally contain clauses to ensure that there is no abuse of the right to use (eg by including maintenance obligations on the part of the lessee, or restrictions on how the asset can be used by the lessee.) Consequently, ensuring the lessee's adherence to those clauses is also a relevant activity of the SE performed, in this example, by the bank.

25. In accordance with View B, neither the lessee's purchase option nor the lessee's use of the leased asset give the lessee decision-making rights over the relevant activities of the SE because the lease was designed to take into account both the

effect of the lessee's use of the asset on the value of the asset and the effect of the lessee exercising the purchase option.

26. Proponents of this view also quote US GAAP (ASC Topic 810-10-55-39) because an operating lease is not considered a variable interest in a lessor if the lease contains only vanilla terms, ie with no off-market purchase or renewal or residual value guarantees:

> Most operating leases do not absorb variability in the fair value of a VIE's assets because they are a component of that variability.

Summary

27. View B is based on the premise that the lease agreement creates the risks that the SE is designed to be exposed to, ie credit risk of the lessee and residual value risk. These risks are managed by the SE or the bank through its actions in monitoring default, monitoring the use of the asset and managing the sale or re-lease of the asset in the event the purchase option is not exercised by the lessee. Under this view, use of the asset is not a relevant activity. Consequently, the lessee would not have decision-making rights over the relevant activities of the SE and would not consolidate the SE. The lessee would recognise the transaction as an operating lease in accordance with IAS 17.

Summary of outreach conducted

28. 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 12B.

29. 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

30. 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

31. Four respondents were not aware of any transactions of this type in their jurisdiction and expressed no preference for accounting treatment.

32. A few of the remaining respondents thought these transactions were probably common, although they had no knowledge of any specific transactions. Few respondents had received any queries on the topic.

33. Their general view is:

    (a) It is too early to say whether there would be diversity in practice, particularly as the Standard is mandatory in Europe only from 1 January 2014.

    (b) A decision about control would need to be made based on a careful analysis of the facts and on a case-by-case basis.

    (c) The submitter had provided insufficient detail about aspects of the transaction (such as the purchase option, purpose and design of the SE and the protective clauses over the use of the asset) to perform this analysis.

    (d) The principles established within IFRS 10 would allow the assessment of control to be completed, however, when all required information is known.

(e) The activities associated with the use of the asset, and that are managed by the lessee, are not likely to be relevant activities of the SE because they do not affect the returns of the SE.

34. Some also think that legal ownership of the asset is not relevant to this analysis. They think that the lease transforms the nature of the asset held by the SE so that it is:

(a) a lease receivable, for which the relevant activity is the management of credit risk; and

(b) a residual value relating to the asset at the end of the lease term, where the relevant activity is releasing the value through sale or re-lease.

35. We note, however, that despite these general views, four respondents think that the assessment required in this example is complex and, consequently, recommend that the Interpretations Committee should clarify the position.

Supplementary information-gathering

36. Because of the lack of reported experience about these types of transactions, we attempted to supplemented our outreach by using:

(a) examples provided by the submitter; and

(b) a review of published financial statements.

Examples provided by the submitter

37. In accordance with our usual requirements, we requested examples of this type of transaction in support of the submission. The submitter was unable to provide any examples, because of concerns about confidentiality.

Review of published financial statements

38. We also reviewed the financial statements of entities in the sectors that we thought should be affected by these types of transactions, eg aircraft and rail manufacturers and operators, to see what effect the application of IFRS 10 had, or will have had, on the entity.

39. We identified seven entities with this type of transaction (four European, one Australian and two North American) preparing financial statements in accordance with IFRS. Five entities stated that no significant effect was expected as a result of applying IFRS 10 in the future; one entity stated they had applied IFRS 10 and there was no significant effect; the other adopter was silent.

40. The reported practice of IFRS preparers, therefore, is that the application of IFRS 10 did not, or will not, change current practice. We note that the accounting policies of the reviewed entities confirm that leases are accounted for in accordance with IAS 17.

41. We think that, if View A were applied on first application of IFRS 10, and this led to some operating leases no longer being accounted for in accordance with IAS 17,. this would result in a significant change in accounting practice that would have to be disclosed by the entity. As noted, the entities reviewed do not think

that practice will change. The corollary is, that operating leases will continue to be accounted for in accordance with IAS 17 by both lessor and lessee. Consequently, we think that View B is more likely to be applied in practice on application of IFRS 10.

Staff analysis

42. In analysing this issue we think that there are three further aspects of the fact pattern to consider in addition to the points made by the submitter:

    (a) the effect on the relevant activities of the SE of the lease being an operating lease in accordance with IAS 17;

    (b) satisfying the other requirements of control; and

    (c) the intention of the Standards, IFRS 10 and IAS 17.

The effect of the lease being an operating lease

43. According to the submitter, the lease is an operating lease in accordance with IAS 17. Consequently, substantially all the risks and rewards of ownership of the leased asset cannot have transferred to the lessee. These are retained by the SE, on the submitter's own analysis.

Requirements of IAS 17

44. IAS 17 provides general guidance on the classification of leases:

> 7. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee….

45. The Standard also distinguishes between a finance lease and an operating lease:

> A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.
>
> An operating lease is a lease other than a finance lease.

46. One of the circumstances that would normally lead to a lease being classified as a finance lease is that ownership transfers to the (finance) lessee. A consequence of this arrangement being an operating lease, therefore, is that ownership of the asset is retained by the SE.

47. In the submitter's analysis of View A, in assessing the relevant activity of the SE, emphasis is placed on legal ownership of the leased asset being retained by the SE. View A proposes that the change in the fair value of the residual value of the asset, caused by the lessee's activities, is the item that will most affect the SE's returns.

48. We do not agree. We think that operating leases are constructed so that the risks and rewards of ownership are with the lessor, but the lease includes clauses to protect the lessor's asset eg by requiring maintenance obligations. Leases are designed so that risks and rewards are apportioned at inception and are not

reallocated or transferred during the term of the lease unless variations to the terms are agreed by both parties subsequently.

49. We think that the only action by the lessee that could affect the returns of the SE in a way not anticipated by the terms of the lease, would be if the lessee had a bargain purchase or extension option. If the lessee could exercise such an option, the return from the sale of the residual asset *could* be varied by the actions of the lessee. The actions of the lessee would result in the SE's returns differing significantly from the returns achievable by the bank.

50. We do not think it is likely that the entity is able to do this. Exercising the purchase option by the lessee cannot affect the residual value of the asset in the following ways *by definition* in IAS 17 (or it would not be an operating lessee):

    (a) the option cannot be at a bargain price (paragraph 10(b) of the Standard);

    (b) gains and losses on residual value cannot accrue to the lessee (paragraph 11(b) of the Standard);

    (c) any extension of the lease cannot be at a bargain price (paragraph 11(c) of the Standard); and

    (d) the lessee is likely to bear any losses associated with early cancellation (paragraph 11(a) of the Standard).

51. We have already noted that one condition of the lease is likely to be that the lessee cannot fail to maintain the asset or otherwise reduce the fair value of the asset. Consequently, we think that it is not how the lessee uses the asset that most

significantly affects the fair value of the asset and the returns to the SE. Instead, we think it is how effectively the bank manages credit risk and negotiates the sale or re-lease of the asset.

52. With respect to the 'power' test of control, we conclude that in this example the lessee is unlikely to control the relevant activities of the SE and, consequently, does not have power over the SE.

Satisfying the other requirements of control in IFRS 10

53. 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).

54. We do not see how an operating lessee can have exposure, or rights, to variable returns from its involvement with the SE. The lessee's arrangements with respect to the right of use of the asset is agreed with the SE at inception. The terms of the use of the asset and the amount and timing of the lease payments are both agreed at inception.

55. In addition, we do not see how the lessee has the ability to effect its returns from the SE. There is no mechanism by which the lessee can extract any value from the SE. The SE's equity is held by the bank. There is no mechanism for the transferring of resources between the SE and the lessee, other than the arrangements made in the lease (transfer of leased asset to the lessee; monthly lease payments; etc).

Intention of the Standards, IFRS 10 and IAS 17

56. We also think that if View A were applied, the effect of that application would contradict the intention of, and underlying principle inherent in, IAS 17. The intention of IAS 17 is that an operating lessee should not recognise the leased asset in its statement of financial position. If the operating lessee in this submission had control over the SE, it would consolidate the SE and, consequently, recognise the leased asset in its consolidated statement of financial position. The submitter acknowledges that the lease is an operating lease, but View A, consolidation of the SE by the lessee in accordance with IFRS 10, would contradict the intention of IAS 17.

57. (One respondent to our outreach also thought that IAS 17 was a more specific Standard than IFRS 10 and, consequently, its guidance should outweigh that of IFRS 10 in any perceived conflict.)

Support for View B

58. Any decision about control of the SE would need to be based on a careful analysis of the facts carried out on a case-case basis. We think that the submitter does not provide sufficient information about some aspects of the transaction, such as the purchase option, the design and purpose of the SE or the protective clauses about the use of the asset, to perform that analysis. We also note that any such analysis would need to be re-evaluated on a significant change in circumstances in accordance with paragraph B80 of IFRS 10.

59. Although the staff are unable to identify which entity would control the SE, the staff thinks that, based on the analysis above, it is unlikely that it would be the lessee and, consequently, supports View B, ie the operating lessee does not control the SE.

60. We think it is likely, based on the information available, that the SE's returns will arise from the following:

    (a) the residual value of the asset;

    (b) credit risk on the lease receivables; and

    (c) financing risks on its interest outflows.

61. The lessee does not have power over these relevant activities.

Assessment against our agenda criteria

62. 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;	**Yes.** We think that the effect on the financial reporting of any entities involved would be material and that this type of transaction is common in some industries, such as airlines and railways.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No.** We have seen no evidence that there is diversity in practice, although we note that IFRS 10 is not yet applied in Europe. We think, however, that the Standards contain sufficient guidance for a consolidation assessment, based on an analysis of the terms and conditions of an individual lease, to be made consistently.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Yes.** We think that the issue could be interpreted within the confines of IAS 17 and IFRS 10.

Paragraph 5.16 states that we should address issues:	Agenda criteria satisfied?
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	**Yes**.
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	**Yes.** There are no current IASB projects that are likely to affect this issue.

Staff recommendation

63. 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 on a case-by-case basis. We do not think that the submitter has provided sufficient detail about aspects of the transaction (such as the purchase option, purpose and design of the SE and the protective clauses over the use of the asset) to perform that analysis in this case. 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.

65. We are not aware, at this stage, of any diversity in practice. We note that the alternative view, View A, received little support in outreach. We also note that a review of financial statements that are likely to include such transactions did not disclose a likely change to existing practice on the introduction of IFRS 10.

66. Accordingly, we recommend that the Interpretations Committee should not take this issue onto its agenda.

Questions for the Interpretations Committee
1. Does the Interpretations Committee: (a) agree with the staff's recommendation that this issue should not be taken onto the agenda; 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 an operating lessee

The Interpretations Committee received a request for clarification about the interaction of IFRS 10 *Consolidated Financial Statements* and IAS 17 *Leases*. In the submitter's example, a structured entity ('the SE') is created to lease a single asset to a single lessee. The submitter asks whether the lessee controls the SE and whether the lessee should consolidate the SE. The lease is an operating lease as defined by IAS 17.

The Interpretations Committee noted that, in assessing the effect of a lease on an assessment of power made in accordance with IFRS 10, it is necessary to make a careful assessment of the facts and circumstances. It concluded, however, that the principles established within IFRS 10 would enable a determination to be made reliably when all required information is known. It also concluded that if the lease is an operating lease, as defined by IAS 17, the lease would be unlikely transfer sufficient rights to the lessee to grant the lessee power over the SE, when assessed in accordance with IFRS 10.

The Interpretations Committee further concluded that it did not expect significant diversity in practice to arise following the implementation of the Standard.

Consequently, the Interpretations Committee thought that neither an amendment nor an Interpretation is required and [decided] not to add this issue to its agenda.