Comments on Tentative Agenda Decision – Assessment of Specified Main Business Activities for a Manufacturer-Lessor (IFRS 18)

The Accounting Standards Board of the Institute of Chartered Accountants of India appreciates the opportunity to comment on the IFRS Interpretations Committee's Tentative Agenda Decision on **"Assessment of Specified Main Business Activities for a Manufacturer-Lessor (IFRS 18)"**.

We acknowledge the Committee's consideration of the question whether, applying IFRS 18, an entity that manufactures vehicles and either sells or leases them to customers should assess its aggregated lease activity, comprising finance leases and operating leases, as a main business activity of providing financing to customers.

We broadly agree with the Committee's analysis of the requirements in IFRS 18. However, considering the practical significance of the issue and the potential diversity in practice, we believe that further clarification would be beneficial. Our comments are set out below.

1. Overall view

We support the Committee's efforts to provide clarity on the application of paragraphs 49 and B30–B41 of IFRS 18 in determining whether an entity has a specified main business activity of providing financing to customers.

However, we are of the view that the fact pattern described in the Tentative Agenda Decision raises a broader question concerning **how an entity should assess an activity when its business model, management reporting and financing arrangements are organised on an aggregated basis, while the underlying transactions are subject to different accounting requirements**.

In our view, the assessment should focus on the substance of the entity's business activities and how those activities are managed and evaluated, rather than placing undue emphasis on whether individual lease contracts are classified as finance leases or operating leases under IFRS 16.

Accordingly, we encourage the Committee to provide additional guidance or clarification on the application of the existing requirements in this fact pattern.

2. Aggregated assessment of finance and operating lease activities

The fact pattern indicates that the entity manages vehicle sales, finance leases and operating leases together in one line of business. Further, the leases do not differ significantly in nature and the entity enters into refinancing arrangements with a bank for each lease contract irrespective of whether the lease is classified as a finance lease or an operating lease.

The entity also uses, for both internal and external reporting purposes, a single subtotal for its aggregated lease activity that is similar to gross profit and includes income and expenses from both finance and operating leases together with interest expenses arising from the refinancing arrangements.

These facts appear particularly relevant to the assessment of whether providing financing to customers is a main business activity.

In our view, where:

- finance lease and operating lease activities are managed together;
- the underlying assets and customer arrangements are substantially similar;
- the entity's financing arrangements are entered into in respect of both types of leases; and
- management evaluates the combined activity using a common performance measure, there is a strong basis for considering the aggregated activity when determining whether providing financing to customers is a main business activity.

We therefore believe that IFRS 18 should make clear that the classification of individual leases under IFRS 16 should not, by itself, determine whether the aggregated activity constitutes a specified main business activity under IFRS 18.

3. Interaction between IFRS 18 and IFRS 16

The issue arises because IFRS 16 requires a lessor to classify a lease as either a finance lease or an operating lease, whereas IFRS 18 requires an entity to assess whether it has a specified main business activity.

These are different assessments serving different purposes.

The classification of a lease under IFRS 16 is based on the transfer of risks and rewards associated with ownership of the underlying asset. By contrast, the assessment under IFRS 18 concerns the nature of the entity's main business activities and, consequently, the appropriate classification of income and expenses in the statement of profit or loss.

Accordingly, we believe that the fact that some lease contracts are classified as operating leases should not, without further analysis, preclude an entity from concluding that its aggregated leasing activity represents a business activity of providing financing to customers.
We recommend that the Committee clarify this interaction to avoid an interpretation that the IFRS 16 classification of an individual lease automatically determines the IFRS 18 assessment.

4. Relevance of refinancing arrangements

We consider the refinancing arrangements described in the fact pattern to be an important indicator in assessing the nature of the entity's aggregated lease activity.

The entity enters into a refinancing arrangement with a bank for each lease contract, irrespective of whether the lease is classified as a finance lease or an operating lease. The refinancing arrangement bridges the difference between the cash flows received under the lease arrangement and the cash flows that would have been received on a sale of the vehicle, and gives rise to interest expense.

This fact indicates that financing is an integral component of the entity's business model rather than merely an incidental source of funding.

We therefore suggest that the application guidance should explain how an entity considers the nature and extent of such refinancing arrangements when assessing whether providing financing to customers is a specified main business activity.

In particular, clarification would be useful on whether financing arrangements associated directly with lease transactions should be considered as evidence of a financing activity even when the underlying leases are classified as operating leases.

5. Importance of management reporting
The Tentative Agenda Decision notes that the entity uses a single subtotal for its aggregated lease activity that is similar to gross profit as an important indicator of operating performance. That subtotal incorporates income and expenses from both finance and operating leases as well as the related refinancing interest expenses.

We believe that this fact should receive significant weight in applying IFRS 18.

Where management internally manages and evaluates an activity on an aggregated basis, such information may provide useful evidence of the nature of the entity's main business activity. A requirement to disaggregate the assessment solely by reference to the accounting classification of individual lease contracts could result in financial statement presentation that does not faithfully reflect how management conducts and evaluates the business.

Accordingly, we recommend that the Committee clarify that management reporting and performance measures may be relevant evidence in determining whether an aggregated activity constitutes a main business activity under IFRS 18.

6. Potential diversity in practice
We are concerned that, without additional clarification, entities with substantially similar economic activities could reach different conclusions depending upon how they structure their lease contracts or internal reporting.

For example, two manufacturer-lessors may:
- manufacture and lease substantially similar vehicles;
- provide substantially similar financing arrangements to customers;
- manage their leasing portfolios on an integrated basis; and
- have substantially similar economic exposures,

but arrive at different conclusions merely because the proportion of leases classified as finance leases and operating leases differs.

Such an outcome may reduce comparability between entities and may not appropriately reflect the economic substance of their business activities.

We therefore believe that the issue has broader relevance beyond the specific fact pattern considered by the Committee.

7. Need for clarification rather than a narrow fact-pattern conclusion
We appreciate that the Committee has tentatively decided not to add a standard-setting project to its work plan. Nevertheless, we believe that the issue could appropriately be addressed through clarification of the existing application guidance, if the Committee considers that a standard-setting project is not warranted.

In particular, we suggest that the final agenda decision should explain more explicitly:
1. whether an entity may assess finance lease and operating lease activities on an aggregated basis when determining whether it has a specified main business activity;
2. how the entity should consider the fact that substantially similar lease transactions are classified differently under IFRS 16;
3. how refinancing arrangements entered into in connection with both finance and operating leases should be considered;

4. the extent to which management reporting and internal performance measures should be considered in the assessment; and
5. whether the conclusion would differ where the entity manages and evaluates its finance lease and operating lease portfolios separately.

Such clarification would assist entities in applying IFRS 18 consistently and would reduce the risk of diversity in practice.

8. Suggested clarification to the application guidance

Without proposing a new requirement, we believe that the existing application guidance could be supplemented with an illustrative example addressing a manufacturer-lessor.
The example could explain that, in determining whether providing financing to customers is a main business activity, an entity considers all relevant facts and circumstances, including:

- the manner in which the activities are managed;
- the similarity of the underlying transactions and customer relationships;
- the manner in which financing is arranged;
- whether financing is integral to the customer proposition;
- the manner in which management evaluates the performance of the activities; and
- the extent to which finance lease and operating lease activities are integrated.

Such an example would be particularly useful because the issue involves the interaction of two different Standards and concerns an assessment based on the entity's business activities rather than the accounting classification of individual contracts.

9. Conclusion

We appreciate the Committee's consideration of this matter and agree that the existing requirements of IFRS 18 provide a principles-based framework for determining whether an entity has a specified main business activity.

Nevertheless, given the specific fact pattern and the potential for diversity in applying the requirements, we believe that further clarification would be useful.

In particular, we recommend that the final agenda decision make clear that:

(a) the assessment of a specified main business activity under IFRS 18 is distinct from the classification of individual leases under IFRS 16;
(b) where finance lease and operating lease activities are managed and evaluated together and are economically integrated, an entity should consider the aggregated activity in determining whether providing financing to customers is a main business activity;
(c) refinancing arrangements associated with both finance and operating leases may provide relevant evidence of the nature of the entity's business activity; and
(d) management's internal reporting and performance measures may be relevant evidence in applying the requirements of IFRS 18.

We therefore request the Committee to consider providing the above clarification in the final Agenda Decision or through appropriate amendments or illustrative guidance, as considered necessary.

We thank the Committee for providing stakeholders with the opportunity to comment on this important matter.