

Hill House
1 Little New Street
London EC4A 3TR
United Kingdom

Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.co.uk
www.iasplus.com



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Mr. Kevin Stevenson, Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Stevenson,

Determining whether an Arrangement contains a Lease

Deloitte Touche Tohmatsu is pleased to comment on the International Financial Reporting Interpretations Committee's (IFRIC) Draft Interpretation 3—*Determining whether an Arrangement contains a Lease* (the draft Interpretation or D3). While an Interpretation in this area may be an improvement to current IFRS, we have reservations regarding the application of the draft Interpretation and the consequences the theory supporting the consensus may cause. We believe our concerns highlight the problems with the theory supporting the proposed consensus.

Applying the draft Interpretation

Components of an Item

The level at which componentisation of an item occurs could impact whether the item (or components thereof) meets the recognition criteria in paragraph 6 and, therefore, whether an agreement is classified as a lease. It is unclear whether or not the draft Interpretation should be applied to components of the item in an arrangement. That is, the current drafting of paragraphs 3 and BC 4 leave the impression that the decision of whether to componentise an item is a choice. We believe this issue highlights the fundamental problem with a test based on output, when the question of 'output from what' is not addressed. We are concerned about the consequences of an interpretation that leaves open this issue and therefore recommend that the final Interpretation either resolve or not address this issue.

The draft Interpretation raises additional questions about what items can be componentised through use of the pipeline example. If an entity can componentise an item that is not physically distinguishable (which half of the pipeline is an entity's half?), then what happens if an entity takes 50 percent of the output from a power station? Does the entity have a lease over 50 percent of that power station? If this is the intention of the draft Interpretation, then could an entity have a lease over 1 percent of its supplier's plant?

We also believe that the flexibility provided by the draft Interpretation related to componentisation is considerable and can be easily structured around. For example, most electrical plants are connected to the national grid (regardless of location) as they are routinely shut down for maintenance purposes. An operator of a gas-powered electricity plant may decide to shut down the plant if it can make more money settling its gas contracts net and purchasing electricity from the grid than generating electricity. Therefore, this arrangement no longer depends on the plant (but only the wires connected to the grid) and would be—based on an entity’s choice of how far down to componentise—out of the requirements of paragraph 6(a).

Specific Asset Criteria

Under paragraph 6(a), an item that is implicitly identified by the contractual provisions of an arrangement will be considered a specific asset if it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative items. If, for example, the operator of the gas-powered electricity plant purchases and sells the electricity purchased from the national grid at a loss, but this loss is smaller than the gain on the gas forward, is this alternative arrangement economically feasible or practical? Therefore, in this case, is the determination of whether the criterion in 6(a) is met at the inception of the agreement dependent upon estimates of future gains on gas forward contracts? In addition, we have concerns about whether the purchaser can practically make an analysis similar to that of the supplier.

Payment for Output

The draft Interpretation does not sufficiently develop a principle or objective to provide guidance on when a minimum payment should be considered a payment for the right to use an asset, rather than for the output from an asset under paragraph 6(c). Is the IFRIC’s intention to require any contract with a minimum payment to meet the criteria in paragraph 6(c)? We also have practical concerns about when the obligation to make payment is “implicit”. For example, would a situation where, although there is no specified minimum payment in the contract, but the purchaser intends to take delivery of all of the output by a supplier (without being legally bound to), be considered to meet this criteria?

Reassessment

D3.7 states that a reassessment of whether an arrangement contains a lease shall be made only in cases where the provisions of an arrangement are changed. We note that a fundamental characteristic of a lease is the right to use a specific asset. Under arrangements where output, among other things, is the basis for determining whether or not an arrangement is a lease, we believe that reassessment should be required where the source of output changes. In these cases, a specific asset may no longer be used, effectively changing the substance of the arrangement, and therefore, its underlying accounting. Furthermore, the notion of reassessment in IAS 17 is related to lease classification, not whether a contract is determined to be a lease. As a result, we see no logical reason (under the proposed model) why reassessment should not be required when the source of output has changed. We also note that requiring reassessment when the source of output has changed is consistent with EITF 01-8 *Determining Whether an Arrangement Contains a Lease*.

Auditability

In many circumstances, the purchaser of a product may not know of the decisions made by its supplier. In other circumstances a purchaser may not know that one piece of specially-designed equipment is needed for only its purchases. For example, assume Company S (supplier) produces 1 inch and 2 inch widgets. Company P (purchaser) would like Company S to make 4 inch widgets. Company S accepts this job from P. Company P may have no knowledge of how S will fulfil this arrangement, but only that it will fulfil the agreement. The search for unrecorded leases would be so onerous as to question whether the draft Interpretation leads to requirements that are verifiable and auditable.

Consequences

Paragraph BC4 notes that componentisation in existing literature is based on physically distinguishable components—a fact that is lost in paragraph 3 and the remainder of BC4. We are concerned about the consequences an interpretation that leaves open how to apply a components approach, but clearly states that an approach based on a percentage of capacity can be taken, will have on applying the requirements of IAS 16 *Property, Plant and Equipment* and IAS 17 *Leases*. For example, we note that paragraph 6 requires that all criteria be met if an arrangement is to be considered a lease. We note that several arrangements currently considered leases may not meet all of the criteria. For example, the payment may be based solely on the output of the item (e.g. number of copies from a photocopier). We believe the interpretation would be strengthened by clarifying whether the criteria in paragraph 6 should apply to all contracts in order to be a lease contract.

In addition, the effects will likely lead to significantly different applications of IAS 16 and IAS 17 for transactions such as airplane leases, indefeasible rights of use, etc. Furthermore, we are concerned about the effects this flexibility will have on revenue recognition under IAS 18 *Revenue*.

We agree with the minority position in BC16. Furthermore, we are concerned that the ability to receive significant output or capacity may now be considered a determining factor in whether an entity has control over another entity—or control over a component of an entity. This may have unintended consequences on IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates*, and IAS 31 *Interests in Joint Ventures* decisions that have not been fully explored in the basis for conclusions.

Recommendation

The draft Interpretation would be strengthened to avoid the unintended consequences noted above if the criteria in paragraph 6(b) were changed to reflect more of what is a right of use. Specifically, some of the criteria in EITF 01-8 may need to be reconsidered such as who has the right/power to operate (or direct others to operate) the asset in a manner intended. We note that this recommendation would lead to greater convergence by bringing the draft Interpretation more in line with US GAAP. We recommend that the final Interpretation resolve our practical concerns around components of assets. If a final Interpretation is issued without resolving this issue, we recommend the issue of components (paragraphs 3 and BC4) be deleted from the Interpretation. It would be our preference, however, that if IFRIC cannot resolve the issue of components, D3 be changed to a disclosure type Interpretation for future commitments under executory contracts in addition to SIC 29 *Disclosure—Service Concession Arrangements*.

We also believe the examples, particularly paragraph E1, are not helpful in that they are imprecise leaving a significant need for additional interpretation (e.g. what is the relative size of fixed versus variable payment needed to meet the criteria in 6(c) and how does one judge economic viability or the practicality position of the supplier).

Because of the consequences this draft Interpretation would have on the application of other IFRS if issued in its present form, we are concerned that an effective date for financial periods beginning prior to 1 January 2006 would significantly affect the “stable platform” proposed by the IASB. While we understand and support the fact that IFRIC must continue to *interpret* IFRS during the proposed “quiet period”, we would strongly encourage IFRIC to refrain from setting new Interpretations that change the generally accepted application of existing standards. We believe our recommended approach would allow for an Interpretation during the quiet period.

Other Comments

We note that the transition provisions EITF 01-08 are prospective, but the transition provisions in D3 are retrospective. We believe, for the same reasons discussed by the EITF, that a retrospective approach would require an onerous review of all contracts previously entered into by an entity over the past several years—maybe in excess of 20 years. For practical concerns, we recommend a prospective transitional approach.

As a matter of principle, we object to references stating consistency of accounting requirements with other accounting principles in a Standard or Interpretation. For example, paragraph BC26 states that “...the IFRIC’s view is that a similar assessment of whether an arrangement contains a lease is likely under both (D3 and EITF 01-08)”. Because of the increased specificity in US GAAP, this statement should not be made unless the IASB and IFRIC intend that US GAAP guidance—by default—is also IFRS guidance. In addition, as noted above, we do not believe EITF 01-08 and D3 are similar and therefore this reference is incorrect. If the IFRIC intends that D3 and EITF 01-8 be similar, we believe there is no justification for using different words.

The last sentence in paragraph 10 presumes that it will be rare that total payments cannot be reliably separated among elements. We believe reliable separation among elements will not be available in more than rare cases and therefore suggest that this presumption be removed. In addition, if the test using minimum payments compared to the fair value of the asset is not available to the entity, we question how practical it will be for an entity to conclude whether a lease is a finance or an operating lease if directed to IAS 17 *Leases*.

The draft Interpretation begins by providing outsourcing arrangements as an example of arrangements that may contain lease. We do not believe this reference should be included as most outsourcing arrangements will not meet the criteria in Paragraph 6(a) and therefore may mislead the users of D3.

We appreciate the opportunity to provide our comments. If you have any questions concerning our comments, please contact Ken Wild in London at (020) 7007 0907.

Sincerely,

Deloitte Touche Tohmatsu

