Aviation Working Group

Summary of Position on Lease Accounting Exposure Draft

September 2013

The FASB and the IASB have been working together to produce a revised accounting standard for leases. The driving force behind the project is the Boards' view that "the existing accounting models for leases…do not require lessees to recognize assets and liabilities arising from operating leases [on lessee balance sheets]." While addressing this issue, they have concluded that "retaining the existing lease accounting models for lessors would be inconsistent with the proposed approach to lessee accounting and would result in additional complexity in financial reporting." They first produced an Exposure Draft (**ED**) in August 2010, and, after reviewing comments, have now produced a revised ED dated May 2013. Comments were due by 13 September 2013. The proposals, if implemented, would change both lessor and lessee accounting in a way that AWG believes will be detrimental to users and preparers of financial statements. AWG does not support the issuance of a new standard based on the ED.

For leases of equipment of longer than one year, the ED proposes the following:

1. Lessees, at commencement of a lease, would recognize the present value of committed lease payments as a liability and the same amount as a "right-to-use asset."
2. Lessees would depreciate the right-to-use asset straight line and amortize the operating lease liability mortgage-style, as if the leased asset was purchased and financed with a loan
3. Lessors would "de-recognize" the leased asset from their balance sheets and replace it with two different assets:
    a. the present value of future lease receipts
    b. the present value of the residual value
4. At the beginning of a lease, to the extent that the aggregate value of the lease and residual assets exceeds the Lessor's carrying value of the asset, the excess would be allocated between the lease and the residual, with the portion attributable to the lease recognized immediately and the residual portion deferred. To the extent that the aggregate value is less than the carrying value, a loss would be recognized immediately.
5. In each case, the present values would be calculated using the "rate implicit in the lease", where this is determinable, or the Lessee's incremental borrowing rate.
6. Leveraged lease accounting would in effect be abolished.

Working through its subgroup for accounting matters, AWG has issued a comment letter in response to these proposals. AWG's views on the ED are as follows:

1. While it may make sense from a regulatory perspective for lessees to recognize an asset and a liability on the balance sheet, tighter footnote disclosure could achieve the same objectives at a lower cost.

2. As the right of use asset is not severable from the operating lease liability, the asset and liability should depreciate/amortize at an equal rate, thus preserving current straight-line expense recognition for lessees, which follows the economics of the lease arrangement. The proposed approach, by contrast, front-loads leasing expense for lessees and creates a potential currency translation mismatch for non-US$ reporting companies.
3. As lessors already recognize the assets leased on their balance sheets, there is no off-balance sheet issue that needs addressing in lessor accounting and there is no need to change long standing accounting principles that have served the needs of investors and management.
4. There is no need for "consistency" between lessee and lessor accounting, as the business models of the two types of entity are completely different and present different sets of issues and perspectives.
5. Removing ("de-recognizing") the assets from an operating lessor's balance sheet, the core of its business model, would not be helpful to users of financial statements.
6. The rate implicit in a lease is not readily determinable in most operating leases and the lessee's incremental borrowing rate is not relevant to the discounting of the residual value.
7. Use of estimates for future residual values, rates implicit in leases and incremental borrowing rates and other assumptions will lead to significant variations in the accounting presentation for similar transactions by operating lessors, thus limiting comparability between the financial statements of different lessors.
8. Realizing profits and losses at the commencement of a lease as a result of use of such estimates will create artificial volatility in lessor financial statements that is not representative of the substance of the underlying contracts.
9. The costs of implementation and periodic reassessment of estimates and assumptions would be considerable, with no substantive benefit.
10. Effectly abolishing leveraged lease accounting is not appropriate, given the unique aspects, including tax benefits, inherent in such arrangements.

In that comment letter, AWG proposed that:

1. If the Boards proceed with requiring recognition of a right-to-use asset and an operating lease liability on a lessee's balance sheet, a unified approach to amortization of both lease elements should be used and there should be no change in expense recognition.

2. The Boards should make no changes to lessor accounting, though perhaps footnote disclosure could be expanded to show the future Net Book Value of assets with leases expiring in future years, thus providing useful information on how much residual asset risk lessors have in their portfolios.

In addition to the AWG comment letter, AWG and IATA issued a joint comment letter on the proposals – which was consistent with the above summary.

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