



AVIATION WORKING GROUP

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Aviation Working Group – Comments on Leasing Project

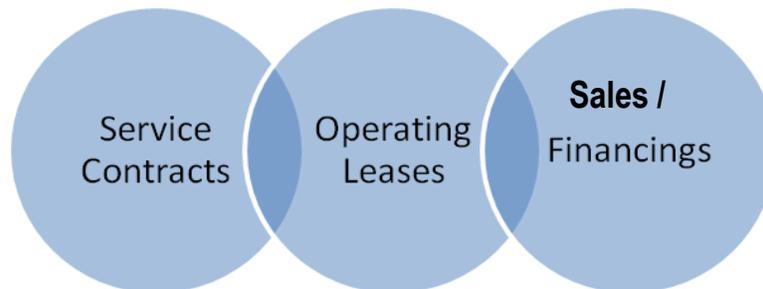
Dear Sir David Tweedie and Ms. Seidman:

The Aviation Working Group (*AWG*) is an industry group whose members consist of the leading manufacturers, lessors and financiers of aircraft and aircraft engines. *AWG* has been closely following and reviewing with interest the leasing project activities of the FASB and IASB (the *Boards*). The Boards' goal to issue a comprehensive leasing standard is commendable and we support the Boards' efforts to develop harmonized accounting standards.

AWG is providing this letter to respond to the questions asked by the Boards following the issuance of the Exposure Draft (*ED*), the Implementation Guidance (*IG*) and the Basis for Conclusion (*BC*).

Leasing spectrum

We believe that leasing has a wide spectrum of purposes ranging from service contracts to sales and financing arrangements. The four proposed leasing models for lessors (specifically leases that are not in scope, derecognition, performance obligation and short-term leases) do not appropriately account for the economics in the wide spectrum of leasing contracts, in particular, without limitation, operating leases.



Service contracts generally do not involve the transfer of a right to use an asset, as the asset remains in the control of the entity providing the service. Operating lease contracts allow for the use of an asset for a specific period of time with no transfer of ownership, such that the lessor retains significant risks and rewards with the asset. Sales and financing lease contracts allow for the financing of the purchase of the asset, with the significant risks and rewards and control of the underlying asset transferring to the lessee.

Lessor accounting

The Boards developed a proposed new lease accounting standard in response to criticism about the current lease accounting guidance. We believe the criticism and need for new accounting guidance is focused principally on lessee and not lessor accounting. We question the need for new lessor accounting guidance as the current guidance is well understood by preparers and users. In addition, we believe that the proposed ED for lessor accounting is not an improvement over existing accounting guidance for the following reasons.

- The two primary lessor models do not account properly for the economics of leasing arrangements.
- The derecognition model is not an improvement over current accounting guidance for finance and sales type leases, as accounting for the residual asset does not match the economics of a lease contract. Moreover, it creates a patchwork of assets by separating the lease receivable from the residual asset.
- The performance obligation model is not an improvement over current accounting guidance for operating leases, since it assumes a financing has occurred and significantly changes the timing of revenue recognition.

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- Implementing the Boards’ proposed guidance will not lead to more decision-useful information, especially for lessors of long-lived assets.
- The Boards’ proposed guidance for lessors involves four possible approaches to accounting for lease contracts rather than the two approaches used today, adding complexity for preparers and users.
- Implementing new lessor accounting guidance will be costly, in particular due to the need to include lease options and contingent payments and the periodic reassessment of such items.

Exclude lessor accounting – address lessor accounting separately

The Boards’ effort to change lessor accounting needs more time and due diligence in order to address this complex area. We encourage the Boards to issue the new lease accounting standard excluding lessor accounting, and create a separate project for lessor accounting. The Boards should consider carrying out additional research and due diligence in order to provide models that properly account for the various leases.

Simple change to lessor accounting – removal of bright lines

If the Boards decide to include lessor accounting in the new lease accounting standard, the Boards should consider a simple modification to current accounting guidance rather than a significant change to lessor accounting, for example the removal of the current bright line rules. Alternatively, the Boards may consider adopting IAS 17 as the guidance for lease accounting. Either approach would help accomplish the Boards’ objectives of harmonized accounting guidance relating to lease contracts.

Changes to lessor approaches proposed in ED

Lease contracts deemed to be sales

The Boards have proposed that lease contracts are outside the scope of the ED if the lessee has exercised a purchase option or if the lessor has transferred control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity, presumably the lessee. We agree that when a lessee exercises a purchase option, other current accounting guidance should govern this purchase. However, we question the exclusion of lease contracts where all but a trivial amount of the risks and benefits associated with the underlying asset has been transferred to lessees. Such lease contracts are more appropriately included in the scope of the new lease accounting standard. The concept of “trivial” will require lessors to perform an additional evaluation of a lease contract when they are already performing an evaluation of the “substantially” concept to determine which lessor approach to follow. Presumably “trivial” is less than “substantially”, and removing the “trivial” evaluation and replacing it with “substantial” would require the lessor only to make an evaluation of the “substantially” concept for its lease contracts, and allow those leases that are more like financing arrangements to be accounted for as sales and financing arrangements.

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We believe the focus of an assessment of whether a contract is a sale or financing should be on the concept of transfer and retention of control, which may include the transfer of significant risks and benefits associated with the underlying asset. We are not aware of a comparable requirement for recognition of revenue in the proposed standard on revenue recognition. It seems that a provision could be added to a lease contract such that the lessor would retain more than a trivial amount of risk and that such a provision may not be of any economic consequence to the parties to the lease. In this case, an in-substance purchase and sale provision as proposed becomes somewhat of an option that would either be in or out of the leasing literature. For example, if a lease contract in which the only risk retained by the lessor relates to a warranty on the asset transferred, the risk retained by the lessor under the warranty could be more than trivial and therefore preclude in-substance purchase and sale accounting. However, the same warranty would not preclude sale accounting under the proposed standard on revenue recognition.

A lease contract is different from a sale contract due to the fact that a lessee obtains control of an underlying asset, compensates the lessor for its use of the underlying asset, and has the ability (or obligation) to then return control of the underlying asset to the lessor at a future date. In such a lease contract, control of the underlying asset is intended and expected to pass from the lessor to the lessee at the beginning of the lease, and then back to the lessor at the end of the lease. Instead of following a risks and benefits transfer assessment, we believe ED paragraph 8 should focus on the likelihood the underlying asset will be returned to the control of the lessor. The wording in ED paragraph 8(a) could be modified to read “a contract that results in an entity transferring control of the underlying asset with no more than a remote likelihood that control of the underlying asset will revert to the lessor.”

A bargain purchase option normally transfers control of an underlying asset and therefore lease contracts with a bargain purchase option should be considered in-substance purchase and sale contracts. We believe the focus should be on the likelihood that control of the asset will revert to the transferor rather than on risks and benefits. The bargain purchase option provision appears to be in conflict with the requirement to transfer all but a trivial amount of risks and benefits to the counterparty. For example, a purchase option that is set at a price expected to be 10 to 20 percent less than the fair value of the underlying asset at the time the option is exercisable is normally considered a bargain purchase option. However, a lessor could still be exposed to more than a trivial amount of risk as it is always possible that the asset could significantly decline in value before the option exercise date. We believe a situation is possible where both the purchase option is a bargain and the transferor is exposed to more than a trivial amount of loss. If the ED required a focus on the likelihood of control reverting to the lessor, this conflict would be resolved.

Finally, we believe that the definition of a lease payment should include the exercise price of a bargain purchase option. Such a change would make the treatment of purchase options consistent with both our suggestion with respect to renewal options and our suggestion with respect to in-substance purchases and sales.

Derecognition approach

The Boards’ proposed guidance in the derecognition approach requires that the residual asset should be recorded at an allocated cost, which would not be adjusted until a subsequent lease or sale of the

underlying asset, an impairment of the residual asset or the termination of the lease. The Boards' proposed guidance does not result in the accounting for a lease contract and the residual asset matching the economics of a lease contract and the residual asset. Lessors treat the residual asset as an investment and expect that over the term of a lease contract the residual asset will accrete to its fair value by the end of the contract. Current lessor accounting guidance for finance leases incorporates this concept. The Boards should consider incorporating the reporting of the residual asset as part of a lessor's investment in a lease receivable, where a lessor follows the derecognition approach.

On the implementation of the new lease accounting standard, lessors will have to measure the fair value of their residual assets. The concept of measuring the fair value of residual assets is not foreign to lessors: they have been assessing these figures under current accounting guidance, and also in order to determine if an impairment of the residual assets exists.

In order to allow lessors to account for residual assets in a manner that is consistent with the economics of the related lease contract and the residual asset, the Boards should consider providing lessors with the option of recording residual assets at their fair value or at the allocated cost.

Performance obligation approach

We believe that there is a major inconsistency between the Boards' proposed revenue recognition standard and the proposed lease accounting guidance. Under the performance obligation approach for lessors, a lessor will record a lease receivable and a performance obligation. However, a lessor is not deemed to have sold any portion of the underlying asset, since the lessor is deemed to have not transferred control of the underlying asset or substantially all the risks and benefits associated with the underlying asset. If a lessor has not transferred substantially all the risks and benefits relating to the underlying asset and has not sold a portion of it (that is, the right to use acquired by a lessee), then recording a lease receivable does not make sense. If a lessor retains substantially all the risks and benefits of the underlying asset, then a lessor has not transferred control. If there has not been a transfer of control of the asset and a sale has not occurred, under the proposed revenue recognition guidance, an entity would not be able to record a receivable for the full amount of payments due from another entity. Instead, we believe an entity would record a receivable each period for the consideration owed by another entity for the use of the underlying asset, similar to accounting for a service arrangement.

The Boards have not addressed in the proposed new lease accounting guidance whether a lease is a transfer of a good or a service. Presumably, since a lessor following the performance obligation approach does not transfer substantially all of the risks and benefits relating to the underlying asset (a concept which is not present in the proposed revenue recognition guidance), a lessor has not sold a good and has not transferred control of the underlying asset, but instead is providing a service to a lessee. Assuming that a lease accounted for under the performance obligation approach is considered a service arrangement with a lessee, it seems appropriate that a lessor should only record a lease receivable (with a corresponding performance obligation) at the beginning of each period during the lease term in which a lessee uses the underlying asset. A lessor would then record the satisfaction of the performance obligation based on the rational measure used by the lessor, normally expected to be the passage of time. Once a lessee makes its lease payment, a lessor would reduce the lease receivable. Instead, under the proposed performance obligation approach, a lessor is initially

measuring the lease receivable and performance obligation at the discounted amount of the expected lease payments, with the lease receivable amortized using the effective interest method and the performance obligation being relieved using a rational method, normally the passage of time. This results in a lessor recording interest income during the term of a lease which is higher at the beginning and lower at the end, and rental income at a lower amount than under current lease accounting guidance.

We recommend that for leases that are accounted for using the performance obligation approach, a lessor should follow the proposed revenue recognition guidance as if the lessor were performing a service for a lessee. We believe that this method would be more representative of the true economics of a lease under the performance obligation approach, since such a lease does not involve a sale or a financing by a lessor.

Determination of lease term and lease payments

The Boards have proposed including options to extend or terminate leases when determining the term of a lease. In addition, the Boards have proposed that the measurement of lease receivables and liabilities should include contingent payments. We do not support either proposal.

Options and contingent payments are conditional rights and obligations that crystallise only when a specific event takes place – either the exercise of the option by a lessee or the occurrence of the event upon which a contingent payment is based. Since a contractual right or obligation would not exist until the occurrence of the related event, we do not understand the basis for the Boards' conclusion that lease options and contingent payments should be recognized and measured as lease assets and liabilities. It is difficult for us to understand the distinction being drawn between an option to renew a lease and an option to purchase an aircraft (or any other asset), an option to purchase services in the future or even an option to rent an asset in the future if the asset has not been delivered to the lessee. We believe the proposed accounting model is inconsistent with the conceptual framework and the accounting for other similar transactions.

In the aircraft leasing industry, options may provide a lessee with a negotiation advantage for future aircraft fleet needs. If an option is above market value, a lessee may renegotiate or look into the market for another lessor. The value of the option at the exercise date, not the lease inception date, is the determining factor for the value of an option as an asset or liability. An astute lessor following prudent and conservative accounting practice would not include an option in the term of a lease where it has concluded that more likely than not the option will not be exercised. If an option is included in the initial lease term for accounting purposes and subsequently not exercised, a lessor will almost always incur a loss.

We further believe that recognizing and measuring lease assets and liabilities that include lease options and contingent payments will lead to significant volatility in financial statements of lessors and lessees without providing decision-useful information. The proposed accounting model will also result in additional work load, as accounting staff generate journal entries that are without economic substance.

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Should the Boards decide to include lease options in the measurement of lease assets and liabilities, we believe there are three possible solutions:

- Use a “reasonably assured” threshold to assess whether an option will be exercised;
- evaluate whether there is an economic incentive or disincentive to exercise or not exercise the option; or
- measure the options at their value.

We believe that the first and second alternatives may be combined in order to arrive at a reasonable solution. We believe that the third alternative would be difficult to apply for certain lessors and would not necessarily provide decision-useful information.

The Boards have concluded that when significant changes in facts and circumstances relating to a lease contract have occurred, the lease term and the lease payments to be received during the lease term should be reassessed. We question the cost and benefit of this requirement. A lessor or lessee would have to review the facts and circumstances relating to all lease contracts once a quarter (for public companies) to assess if there were any significant changes. This effort will result in higher personnel and infrastructure operating costs.

Should the Boards decide to include contingent payments in the measurement of lease assets and liabilities, we believe that the Boards should provide improved and simplified guidance relating to the expected outcomes measurement method, consider a “best estimate” approach, and align such guidance with current accounting guidance in IAS 37 and the revenue recognition project.

Transition

Leveraged leases

The Boards have proposed that accounting for certain leases as leveraged leases will not be allowed. We recommend that the Boards revisit their conclusion. Leveraged leases are based on unique circumstances, including tax treatment, and continue to be used as a viable and efficient means to finance long-lived assets in our industry. Should the Boards elect to eliminate leveraged lease accounting, we recommend that leveraged leases in existence at the implementation date for the new lease accounting guidance should be allowed to run their course with no adjustment due to the new lease accounting guidance. A lessor will incur costs to unwind leveraged lease accounting, under either lessor accounting approach, without realizing a benefit from such effort.

Implementation

We provide a comment later in this paper on the implementation of the new lease accounting standard. We believe that the simplified retrospective approach will not appropriately reflect proper accounting for lease contracts, since the commencement date for a lease contract will be the earliest implementation date. We support providing lessors with the option of applying the new lease accounting guidance on a prospective basis, with appropriate disclosure about the effect of such adoption method, or on a full retrospective basis. A full retrospective implementation would involve a higher level of costs for a lessor as a result of personnel, operational and information system resources needed for compliance. If a full retrospective implementation is selected by the Boards,

lessors should have an adequate amount of time for implementation so that they may properly account for lease contracts during the time between issuance of the new standard and the year in which the new standard is adopted. We recommend that the Boards consider the SEC five year reporting requirements when selecting the amount of time provided for implementation of the new lease accounting standard.

We provide answers and comments to the Boards' questions below.

The accounting model

The exposure draft proposes a new accounting model for leases in which:

- (a) a lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraph 10 and BC5-BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.
- (b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23-BC27).

Question 1: lessees

- (a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- (b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you apply?

Answer

The Boards have concluded that a lease contract contains rights and obligations for a lessee that create a right-of-use asset and a liability. We understand the desire of the Boards to have lessees recognize these balances in their financial statements. We agree that in general a lease contract results in a lessee obtaining a right-of-use asset and includes a liability for its lease payment obligation. .

However, we believe that the Boards need to provide improved guidance in the ED or BC about how option periods and contingent or variable lease payments that are included in the measurement of the lease obligation meet the definition of a liability.

While we acknowledge the Boards' desire to have lessees record lease assets and liabilities, we do not believe that the Boards' guidance relating to amortization of a lessee's right-of-use asset or recognizing interest on a lessee's liability to make lease payments reflects the true economic intent of

a lease that is not a purchase, such as where title transfers or a bargain purchase option exist. We also do not believe the proposed separation of assets and liabilities is consistent with other areas of the accounting literature, since the lessee may not separately settle the separate legs of the transaction. When viewed from a lessor-customer perspective, the asset and obligation component of a lease transaction are not distinct. We understand that the Boards believe that reporting a lessee's costs as proposed more appropriately reflects the purchase and financing of a right-of-use asset.

We urge the Boards to consider linking the amortization of a lessee's right-of-use asset and lease obligation such that the balances remain equal during the term of a lease. In addition, we believe that a lessee should record lease expense on a straight line basis over the term of a lease. We understand that this view is contradictory to the Boards' current lease accounting proposal. However, we believe that our recommendation accomplishes the Boards' objective of reflecting lease assets and liabilities on a lessee's balance sheet and at the same time correctly represents lessees' operating performance.

Question 2: lessors

- (a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks and benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative model would you propose and why?
- (b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?
- (c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

Answer

In the beginning of this position paper, we expressed our views on the accounting approaches proposed by the Boards in the ED.

We believe that lessors should assess the lessor accounting approach based on whether control of the underlying asset has transferred, which may include consideration of whether the lessor retains significant risks and benefits associated with the underlying asset. We believe that the Boards should include the concept of control by lessors in the guidance on which lessor approach should be followed for recognition and measurement of a lease contract.

Question 3: short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

- (a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use

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asset at the undiscounted amount of the lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Answer

With the proposed simplified requirements for short-term leases, we appreciate the Boards' consideration of the administrative burden caused by leases with a maximum rental term (including renewal options) of one year or less. We believe that lessees should have the same options for accounting for short-term leases as those provided to lessors. Lessees should be able to choose on a lease-by-lease basis not to recognize assets or liabilities arising from a short-term lease in the statement of financial position. Instead of the proposed option to record undiscounted amounts, lessees should be able to recognize the cost of short-term leases on a straight-line basis consistent with current accounting guidance. This would align lease expense recognition with lease economics. It also avoids the significant effort and costs associated with accounting for and measuring such short-term assets and liabilities. This approach would also be consistent with the approach and practice many entities use today with respect to fixed asset thresholds, in that assets with a useful life of less than a year are normally expensed as incurred. Short-term leases provide an economic profile different than longer term leases. The difference in risk profile provides a control that limits the chance that these transactions would provide an opportunity for abuse.

We agree with the Boards' proposal that a short-term lease is one with a maximum possible lease term of twelve months or less.

We believe that lessors should not change their current accounting for short-term leases when the new lease accounting standard is implemented.

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1-B4 and BC29-BC32). This exposure draft also proposes guidance on distinguishing between a lease and a purchase or sale (paragraphs 8, B9, B10 and BC59-BC62) and on distinguishing a lease from a service contract (paragraphs B1-B4 and BC29-BC32).

Question 4

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

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- (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance in paragraphs B1-B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what alternative guidance do you think is necessary and why?

Answer

We agree with the Board’s definition of a lease, subject to our comments in this paper. Please refer to our opening comments relating to the scope of contracts that should be included in the new lease accounting guidance.

The guidance provided for distinguishing between leases and service contracts is not sufficient. The proposed guidance will result in entities accounting for similar transactions in significantly different ways. The Boards should reconsider paragraph B1 relating to when a “contract depends on providing a specified asset” and when a “contract conveys the right to control the use of a specified asset.”

Contract depends on providing a specific asset

Under current lease accounting guidance, the embedded leases within a service arrangement are often classified as operating leases. Since the accounting for service arrangements and an operating lease is similar, separating the two components in practice has presented few issues. Under the proposed guidance, any embedded lease in an arrangement will need to be separated and will result in the recognition of lease assets and liabilities. This new guidance will require considerably more judgment and may lead to significant diversity and administrative complexity in practice.

We do not agree with the conclusions relating to a lease embedded in a service arrangement. As proposed, the guidance varies from that under the exposure draft on revenue from contracts with customers.

We believe that the distinction of whether or not the lessor rarely substitutes the underlying asset in question, as proposed in this exposure draft, is the wrong criterion. The current guidance (for example on assets specifically identified and control regarding the outputs) is appropriate to determine whether there is an embedded lease. If the assets can be interchanged or substituted by the lessor, the lessee does not unilaterally control the underlying asset and therefore the contract fails to meet the definition of a lease, since the fulfillment of the contract is not dependent on providing a specified asset. In these situations, the lessee’s “right to use” the asset is restricted and distinguishing “control” based on the likelihood of replacement is impractical to apply in practice. Moreover, in these situations the lessee typically does not believe it controls or has a unilateral right to use the underlying asset, but rather that the lessor controls the asset which is the means to deliver the contracted services – the primary element of the contract.

As a result, if the contract does not specifically identify assets in some manner or the lessor can interchange or substitute the asset at its discretion with little or no penalty or adverse operational

consequences, we believe the contract does not meet the definition of a lease and the service contract should follow the guidance within the revenue recognition exposure draft. We believe that concentrating on “control” of the asset is the critical element for determining whether a lessee has a right to use the asset.

Contract conveys the right to control the use of a specified asset

We also believe that the criterion detailed in paragraph B4(e) should be revised to clarify what is meant by the term “contractually fixed price per unit of output”. We believe there is considerable diversity in practice in how this key quantity is defined. Without additional guidance, we believe that this diversity in practice will continue upon adoption of the final standard resulting in pronounced differences in accounting and financial reporting for essentially similar transactions.

When considering what represents a “contractually fixed price per unit of output” today, some companies and accounting firms hold to a strict definition whereby the price is considered fixed only if it is established at the inception of the contract and does not change over the life of the contract. Other companies and accounting firms take a more liberal interpretation of what “fixed” is by allowing for the price to change over time but only in a manner prescribed in the contract. At present, this difference in interpretation often results in economically similar contracts being accounted for in different ways. However, the current accounting for leases makes this a moot issue in most cases given the similar accounting afforded to operating leases and executory contracts.

Common examples of pricing mechanisms that can be considered “contractually fixed” include: (i) contracts that specify a different fixed price per unit for each year of the contract; (ii) contracts where the pricing of the output is based on a fixed formula that incorporates the future costs to produce the output (such as indexes); (iii) contracts that specify different fixed prices based on the timing of the delivery of the output (such as seasonal pricing); and (iv) contracts where the price is initially fixed with an annual adjustment for inflation. We believe that under current practice some entities and accounting firms would conclude that one or more of these pricing mechanisms do not meet the definition of “contractually fixed”. At the same time, we believe that all of these pricing mechanisms meet the spirit that a contract that contains one of these pricing conventions does not, by virtue of the pricing mechanism, convey the right to use the underlying asset.

We therefore encourage the Board to consider these examples and clarify what is meant by “contractually fixed price per unit of output” to eliminate the current diversity in practice.

Scope

Question 5: scope and scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposals to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33-BC46).

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Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

Answer

We believe that the Boards' proposal establishes harmonized scope for the new lease accounting standard. We believe that the Boards should harmonize accounting for leases of investment property in order to provide consistent financial reporting practices among U.S. and international preparers. Alternatively, the Boards may consider whether lease transactions for long-lived assets should be included in the scope of the Boards' future project on leasing for investment property.

Question 6: Contracts that contain both service and lease components

The exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not distinct:

- (a) The FASB proposes that the lessee and lessor should apply the lease accounting requirements for the combined contract.
- (b) The IASB proposes that:
 - i. A lessee should apply the lease accounting requirements to the combined contract.
 - ii. A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
 - iii. A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Answer

We agree with the Boards' proposal for lessees to account for lease contracts with service and lease components following the lease accounting guidance. We do not agree with the divergence of positions between the FASB and the IASB for lessors. We believe that the Boards should resolve their differences and that one approach should be provided for lessors.

If the lease and service components are not distinct, we agree with the FASB proposal that lessors should apply the lease accounting requirements to the whole lease contract. If the lease and service components are distinct, we believe that lessors should account for the lease components following the lease accounting guidance and should account for the service components following the revenue recognition guidance.

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We agree that the criteria provided in paragraphs B5-B8 provide an appropriate means to identify whether the service and lease components are distinct, except that we do not agree that a distinct profit margin should be a factor. In addition, we believe that the concepts of executory costs that exist in current accounting guidance should be included in the new lease accounting standard as a means to differentiate the service and lease components.

Question 7: purchase options

The exposure draft proposes that a contract ceases to be a lease when an option to purchase the underlying asset is exercised. Thus a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for a purchase option and why?

Answer

We agree that a purchase option should only be recognized when exercised, as a lessee or a lessor do not have any obligations or rights until such exercise. However, if the Boards retain their position that the term of a lease should take into account options to renew or terminate a lease, then they should provide a justification for not also including purchase options as part of the measurement of lease transactions. A decision to exercise a purchase option involves consideration of the same factors as a decision to exercise a renewal or termination option.

If the Boards decide that purchase options should not be recognized, the Boards could improve the new lease accounting guidance by indicating that a purchase option is not a financial instrument.

In our industry, residual and asset value guarantees are often arranged specifically for lease contracts between a lessor and a third party unrelated to the lessee. A lessor will include such guarantee arrangements in its evaluation of pricing and risk with the lessee. We believe that residual and asset value guarantees associated with lease contracts should be included in the evaluation of the accounting of and reporting for lease contracts as if the lease and guarantee contracts were combined.

Measurement

The exposure draft proposes that a lessee or a lessor should measure lease assets and lease liabilities arising from a lease on a basis that:

- (a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16-20 and BC114-BC120)
- (b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease contract by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121-BC131). Lessors should

only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be reliably measured.

- (c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132-BC135).

Question 8: lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

Answer

We do not agree that using the longest possible term is an appropriate methodology. Such an approach may result in recognizing the effect of an option to extend or terminate a lease when such option has not been exercised. The exercise of an option is the event that creates the rights and obligations associated with the option. Recognizing the effect of such options will result in the recording of assets and liabilities before they exist, and will not be consistent with the Boards' definitions of assets and liabilities. If the Boards conclude that options to terminate or extend a lease should be considered when determining the longest possible lease term, the Boards should provide guidance in the standard or the basis for conclusion as to how such options meet the Boards' current and future definitions of assets and liabilities, and the lease term should be measured using a reasonably assured standard.

Question 9: lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease contract should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that a lessor should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

Answer

We do not agree with the Boards' proposed approach to measuring payments resulting from options to terminate or extend leases. We do not believe that options to extend or terminate a lease and contingent payments represent contractual rights or obligations until the options are exercised or until the contingent events have occurred. Before such time, options and contingent payments merely

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constitute conditional rights or obligations. As a result, we do not believe that there is an appropriate basis, using the Boards' definitions of assets and liabilities, to recognize lease assets and liabilities for these items.

We do not believe that the expected outcome technique is the appropriate means to measure the payments because: (i) this method will lead to a result that is not indicative of the actual outcome; and (ii) this method will likely lead to additional costs to develop and implement models to derive the expected outcome, and information systems to capture the necessary data. The expected outcome approach could lead to a model which is based on mathematical probabilities that do not appropriately reflect relevant information and meaningful judgment. The Boards need to consider if the significant costs of applying an expected outcome technique outweigh the potential benefits of providing decision-useful information. We believe that a best estimate approach, similar to the revenue recognition method, would be preferable. Such a method allows for an entity to consider relevant contractual and non-contractual factors and exercise the appropriate judgment.

If a best estimate approach is used, we believe that a requirement for a reliable measurement is appropriate, assuming that this estimate considers contractual and non-contractual factors, including a lessor's experience. If a best estimate approach is not used, then the expected outcome technique should be defined as limited to results that are likely to occur. If such a change is made, then there is no need for a reliable measurement, as a model that produces outcomes that are achievable would incorporate reliable measurement. If the Boards believe that reliable measurement should be included in the lease guidance, we believe that this requirement should apply to both lessors and lessees. Applying this requirement to lessors only is not logical.

In addition, the Boards need to provide guidance for lease contracts that contain rights to receive contingent rentals and a right that a portion of rent may be refundable to the lessee based on specific terms in the lease. We believe that the net inflow or net outflow of these contingent rents should be considered in the assessment of the lease payments.

Question 10: reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

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Answer

We do not agree with the Boards' proposal that lease assets and liabilities should be remeasured when there are significant changes arising from the lease term or contingent payments since the last reporting period. Options to extend or terminate a lease and contingent payments do not give rise to contractual rights and obligations until the options are exercised or until the contingent events occur. As a result, lessors and lessees should not recognize assets and liabilities until the exercise of the options or the occurrence of the contingent events. The Boards have not provided adequate guidance as to how including lease options and contingent payments meet the Boards' definitions of assets and liabilities.

We question whether the Boards have appropriately balanced the costs and benefits of this proposal. Lessees and lessors will need to invest significant resources of personnel, process and systems in order to meet this requirement. It is not clear that the requirement will provide decision-useful information to users of an entity's financial statements. We recommend that the Boards use input from roundtable discussions and comment letters and give appropriate consideration to the costs and benefits of this proposal.

If the Boards conclude that lease options and contingent payments should be included in the measurement of lease assets and liabilities and periodically reassessed, we believe that reassessment should only be carried out when a material change has occurred. In addition, the Boards should include guidance on remeasurement of lease assets and liabilities by lessors in the event of lease asset impairment.

We provided an earlier comment on whether options should be included in the lease term.

We believe that the Boards' guidance on reassessment of lease term and lease payments needs to address commonly occurring events for lease contracts, including novation, amendments, restructuring and business combinations. When these significant lease events occur, we believe that a lessor should also be able to reevaluate whether the derecognition or performance obligation approach which was initially selected remains appropriate.

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Sale and Leaseback

This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66-67, B31 and BC160-167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose?

Answer

We believe that sale and leaseback transactions should be separately evaluated. A sale transaction should be evaluated following the proposed revenue recognition guidance. A leaseback transaction should be evaluated following the proposed lease accounting guidance.

We do not agree that a lessor who qualifies for a sale and leaseback transaction should be required to account for the lease as a performance obligation as outlined in paragraph 68(a). The lessor should analyze the lease transaction and account for the lease using the appropriate lessor approach.

Presentation

The exposure draft proposes that lessee and lessors present the assets and liabilities, income (or revenue), expenses and cash flows arising from lease contracts separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25-27, 42-45, 60-63 and BC142-BC159).

Question 12: statement of financial position

- (a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143-BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in its statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? What alternative presentation do you propose and why?

- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 80, BC154 and BC156)? Why or why not? What alternative presentation do you propose and why?
- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose the information in the notes instead?

Answer

- (a) We agree that a lessee should separately present lease right-of-use assets and lease obligations separately in its financial statements, either on the face of the statement of financial position or in the notes to its financial statements. We believe that a separate presentation is meaningful and necessary to provide users of financial statements with separate decision useful information about assets that a lessee owns or leases.
- (b) Assuming the Boards do not change the proposed guidance for the performance obligation approach, we agree that for leases reported using this approach, a lessor should present net assets and liabilities in its statement of financial position. We believe that the appropriate presentation for the underlying asset, lease receivable and performance obligation is in the notes to its financial statements. Presenting this data in such a manner would provide the user with decision-useful information.
- (c) We agree that a lessor should present lease receivables separately from other financial assets and residual assets separately from other property, plant and equipment for leases reported using the derecognition approach. This presentation should either be on the face of the statement of financial position or in the notes, at the lessor's option and dependent on materiality, and would provide decision-useful information for users. Current accounting guidance provides for the residual asset to be included in a lessor's finance lease receivable. We believe it is more appropriate to report the residual asset as a lessor's investment and include the residual asset with the finance lease receivable.
- (d) We do not believe that assets and liabilities relating to sub-leases should be presented separately from assets and liabilities relating to leases reported using the derecognition and performance obligation approaches. Sub-leasing is a normal activity of lessors and would be more appropriately presented with its leasing assets and liabilities. Lessors should provide information in their notes to financial statements about sub-leasing activities if such information is material and provides decision-useful information.

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Question 13: income statement

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? Why or why not?

Answer

Assuming the Boards retain their proposed guidance on lessor accounting, we believe a lessor should separately present amortization expense, lease rental income, interest income and interest expense, if material, on the statement of comprehensive income.

We believe that a lessee should combine amortization and interest expense and present the combined amount as lease expense on the statement of comprehensive income, if material, or should disclose the components of lease expense in the notes to its financial statements. By presenting the information in this manner, a lessee would provide users with decision-useful information.

Question 14: statement of cash flows

Do you think that cash flows arising from lease contracts should be presented on the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Answer

A lessor and a lessee should separately present cash flows from lease contracts on the statement of cash flows if the amounts are material. Otherwise, disclosure in the notes would be appropriate. The users of a lessor's or a lessee's financial statements should be able to have access to the cash flow information from lease contracts, if such information is material. We believe that lessors should present the cash flows from lease contracts consistent with current accounting guidance.

Disclosures

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing, and uncertainty of an entity's future cash flows?

(paragraphs 70-86 and BC168-BC183) Why or why not? If not, how would you amend the objectives and why?

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Answer

We agree that lessors and lessees should provide qualitative information about amounts recognized in their financial statements relating to lease contracts. Lessors and lessees should provide qualitative disclosure in the notes to their financial statements relating to their lease accounting policies and their leasing activities.

We believe that a lessor and a lessee should include in their qualitative disclosures an explanation of how they manage lease cash flows, including risks relating to uncertain cash flows. We agree that a quantitative disclosure in the notes to the financial statements would be appropriate for the amounts and timing of lease cash flows. While we understand that the Boards believe that disclosures of the nature of cash flows should be included in the financial statements, we believe that a quantitative disclosure of the cash flows, disclosures about the credit quality relating to lease receivables (as proposed in the FASB's recent amendments to the Accounting Standards Codification (*ASC*)) and the qualitative disclosures relating to leasing activities are adequate disclosures to enable users to understand the nature, extent and timing of leasing cash flows. We do not believe that additional disclosure about the uncertainty of cash flows is necessary.

We interpret the disclosure requirements as being mandatory in quarterly filings. Quarterly disclosure will be excessive and should be more limited in scope. The disclosure requirements would be more acceptable if only required annually when there is more time to accumulate, summarize and report the data. Large U.S. SEC filers have 40 days to file their Form 10Qs. With the processes involved in quarterly filings, including auditor reviews, audit committee clearance and XBRL, there would not be enough time for extensive quarterly disclosure. Disclosures for larger companies would not be expected to change materially on a quarterly basis. Given that quarterly disclosures would be similar to annual disclosures, we do not believe users would benefit from such quarterly disclosure. Quarterly disclosures should focus on any significant changes that occurred since the year-end disclosure.

Transition

Question 16

- (a) The exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- (b) Do you think full retrospective application of these accounting requirements should be permitted? Why or why not?
- (c) Are there any additional transition issues the boards need to consider? If yes, which ones and why?

Answer

We believe that a fundamental tenet of any new standard is that its application results in decision-useful information for investors, which can only be achieved if stakeholders are offered the necessary

time to thoughtfully contemplate each new proposal and provide the Boards with meaningful feedback to ensure the final standards are of the highest quality and result in improvements to our existing financial reporting model. We also recognize that each new standard will have a different magnitude of impact to different industries; however, we believe there are concerns that would likely be shared by all industries, including:

- the ability to manage, educate, and communicate to senior management, boards of directors, audit committees, investors, and analysts regarding the changes and related impact resulting from the adoption of new standards;
- the availability of external resources, including consultants and auditors, similar to the resource constraints that occurred during the implementation of Sarbanes Oxley;
- the availability and time required by companies' auditors to plan, understand, and test new processes, controls and data resulting from the changes in accounting standards;
- the premiums associated with the accelerated audits performed by auditors necessary for them to render an audit opinion;
- the impact to companies' business models and strategies; and
- entity-wide training.

Given the importance of convergence topics, particularly the lease and the revenue recognition standards, and the broad potential impact of the proposed standards, we believe that field-testing is necessary to ensure that the final standards are both operational and provide an improvement over existing financial reporting. We encourage the Boards to re-expose the proposed standards if significant changes are made to the accounting and disclosure models set forth in the Exposure Drafts. We believe these steps should be taken to ensure standards are fully vetted even if it is likely to result in delays to the agreed convergence timeline.

The transition methods within the proposed standards sometimes require retrospective application and presentation. We believe retrospective application for the proposed new lease accounting and revenue recognition standards is impractical and cost-prohibitive. We recommend the proposed standards include application guidance that considers when retrospective treatment may be impractical, such as that in FASB Accounting Standards Codification 250, Accounting Changes and Error Corrections (ASC 250), which states that this is the case when:

- an entity is unable to apply the requirement after making every reasonable effort to do so;
- an entity is required to make assumptions about management's intent in a prior period that cannot be substantiated; and/or
- an entity is required to make estimates of amounts for which it is impossible to distinguish objective information about those estimates at the time they were made.

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We suggest that the proposed guidance be applied prospectively for lease contracts entered into with customers on or after the effective date of the standard. Historically, other major revenue recognition standards have been applied on a prospective basis, including most recently Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements, and Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements that Include Software Elements. To address the Boards' concern regarding the preservation of trend information about leasing transactions, we suggest that entities be required to disclose information, where practicable, that enables financial statement users to understand the effects of the change in accounting principles, in the spirit of ASC 250.

If the Boards decide that the new lease accounting standard should be implemented with simplified or full retrospective reporting, companies would need a sufficiently long lead-time to assess the substantial system, process, and policy implementation challenges which would result. It will take significant resources to implement this standard on a retrospective basis, given the long-term nature of our contracts. We recommend that if retrospective application is required, the adoption date be at least five years from the date of final standard issuance.

Benefits and costs

Question 17

Paragraphs BC200-BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals outweigh the cost? Why or why not?

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Answer

We believe that the requirement to periodically assess, as often as quarterly, the lease term and lease payments will result in a significant cost to lessors and lessees, and question whether users will benefit significantly from these changes. In addition, by effectively including all leases under the scope of this draft new guidance, lessors and lessees will be increasing the level of accounting, information systems, operational and management support needed each reporting period, which for U.S. public companies means each quarter. Current lease information systems have not been developed to handle the proposed lease accounting guidance. Lessors in our industry estimate that the development time needed for lease information systems may be one to two years. Significant operating costs will be incurred as lessors and lessees account for leases under the new and current accounting guidance during the time between issuance of the new lease accounting standard and the implementation date. We understand that the Boards have obtained input from various groups as part of their process. However, we believe that since the ED represents the first document that presents the Boards' complete proposal for a new lease accounting standard, especially for lessor accounting, the Boards need to refresh their input from both preparers and users. Given the vast number of leases which will be in effect at the implementation date, the significant cost to adopt and follow the new accounting guidance cannot be underemphasized.

Other comments

Question 18

Do you have any other comments on the proposals?

Answer

Exposure Draft

We present below comments on specific sections of the ED.

1. Inception vs. commencement of a lease

The Boards propose that a lessor should select the derecognition or the performance obligation approach at the inception of a lease, which is defined as the earlier of the lease agreement and the date of commitment by the parties to the provisions of the lease. We do not agree with this proposal. We believe the lease commencement date (the date on which the lessee or lessor performs any obligations under the lease), is the most appropriate date to determine which approach to use and when to recognize and initially measure assets and liabilities arising in lease contracts. In the aircraft industry, the time between the inception and commencement dates for a lease can be long – often two to five years. This lead time is in part due to the long manufacturing cycle for aircraft and the need by lessors and lessees to have firm timing for the manufacture of the aircraft. Therefore, one should expect that there will be significant changes in the cyclical aircraft market during such lead time and so it would be inappropriate to evaluate the risks and benefits associated with the underlying aircraft

until the lease commencement date. Between the lease inception and commencement dates, numerous factors that relate to the underlying asset may change, affecting the selection of the lessor accounting approach. We propose that a lessor should select the appropriate approach at the lease commencement date.

The Boards propose that a lessor following the performance obligation approach should measure lease assets and liabilities at the inception of a lease. Between inception of a lease and commencement of a lease, a lessor would not adjust its initial measurement of its lease assets and liabilities. However, a lessor does not generate a right to receive lease payments until it delivers the underlying asset to the lessee and the lessee accepts such underlying asset. The time between inception and commencement of a lease may be great. During such time, the lessor's risk associated with the lessee and the underlying asset may change significantly. The Boards' proposed guidance does not allow a change in the initial measurement of a lessor's lease assets and liabilities.

Between inception of a lease and commencement of a lease, the incremental borrowing rate for a lessee may also change significantly. A lessee does not have any obligations under a lease contract until the underlying asset is accepted. Since a lessee has no contractual obligation to pay a lessor at the lease inception date, it is not logical to measure the lessee's lease liability and asset using an incremental borrowing rate at this date. We propose using the lease commencement date as the time for initial measurement by a lessee.

A lessor and a lessee may incur significant direct costs between the inception and commencement of a lease. While these costs may be estimated for the purposes of initial measurement, this process will be subject to error.

The Boards have tentatively concluded that lease assets and liabilities arise at the inception of a lease. We do not agree with this conclusion. At the inception of a lease, the lease assets and liabilities are entirely conditional upon the delivery of the underlying asset by the lessor and acceptance of the underlying asset by the lessee. We believe that the Boards have ignored this critical economic and contractual item in their conclusion.

We believe that the initial measurement of lease assets and liabilities should not occur until lease commencement, the date upon which the rights and obligations in a lease contract, other than delivery and acceptance of the underlying asset, become enforceable. If the Boards do not revise their proposed guidance, then they should allow lessors to amend their initial measurement by recording adjustments to assets and liabilities arising between the lease inception and commencement dates, without incurring expense or recording income. The Boards also need to clarify that the present value calculation is based on the commencement date which is set on the inception date.

If the Boards decide to retain this guidance, in paragraph 33, we recommend stating that "in the lessor derecognition model, a lessor has a right conditional upon the commencement of the lease to receive lease payments and an obligation to deliver the underlying asset to the lessee."

2. Impairment of the residual asset – preparers reporting using U.S. GAAP

Paragraph 59 indicates that a lessor shall apply either Topic 350 or Topic 360 at each reporting date to determine whether the residual asset is impaired. Topic 350 covers the accounting for intangibles and topic 360 covers the accounting for property, plant and equipment. Topic 350's impairment model is fair value. Topic 360's impairment model is recoverability based on undiscounted cash flows. It appears that the Board is providing two options for the impairment model. The Board should clarify how to select the appropriate model. We believe that the appropriate model needs to reflect the associated asset. If the residual value is included within property, plant and equipment then Topic 360 should be followed.

3. Impairment of assets – performance obligation approach for lessors

The performance obligation approach results in recognition of a lease receivable and an underlying asset. These two assets will be periodically evaluated by a lessor for impairment. When performing this evaluation, a lessor will normally assess the cash flows expected to be generated by these two assets. Given that two assets will benefit from the same cash flows, it is not clear how the cash flows should be allocated among these two assets. Presumably, the same cash flows would not be used to assess the recoverability of both assets. Assuming that the Boards decide to retain the performance obligation approach for lessors, we recommend that they direct that the impairment test should be performed on the net asset that is reported, that is the net of the lease receivable, underlying asset and performance obligation. They should also include guidance on how the results of the impairment test should be allocated among these two assets and one liability.

4. Guarantees

Lessors and lessees may arrange guarantees with third parties relating to the future asset and residual value of the underlying assets. Such guarantees are economically significant to a lease contract but may not be integrated into the contract itself. However, these guarantee arrangements are directly linked to the underlying asset in a lease contract. When a lessor or lessee uses such guarantees to protect the value of the underlying asset during or at the end of a lease contract, we believe that these arrangements should be combined with the lease contract in order to determine the appropriate accounting for the lease contract. We recommend that the Boards' guidance permit such combining of contracts, since they are economically integral to the leasing contract.

5. Amortization of lease asset and liability

The boards have taken the approach that uncertainty should be addressed through recognition, including the following matters:

- the lease term should be the longest possible lease term that is more likely than not to occur; and
- contingent rents would be included based upon the expected contingent rent obligation.

During the comment letter process for the Discussion Paper (*DP*), several reviewers expressed the opinion that it was not correct to include these amounts in the lessee obligation or the lessor

receivable, as these items did not meet the definition of a liability or an asset. In addition, it is worth noting these elements of the transaction will frequently have only nominal fair value, especially if the renewal or purchase option is based upon fair market values. Since the lessee obligation under the right-of-use model is not related to the lessee's economic liability, it is possible the Boards' approach will produce unexpected results. One such situation is the case of a ten year lease with a ten year fair market value renewal option at year ten. If this lease is recognized as a 20 year lease and a lessee did not exercise the renewal option at the end of 10 years, an accounting gain would inevitably result, given the straight line amortization of the right-of-use asset and the mortgage style amortization of the lease obligation. The Boards may have previously considered this fact pattern during their deliberations on changes in amounts payable under leasing arrangements. We believe there are three possible ways to deal with this situation:

- First, the Boards could choose to accept it as a natural result of the computation of the lessee obligation. This would enable companies to recapture the over-amortization of the asset through a decision to not renew a lease.
- Second, the Boards could allow lessees to amortize the asset so that at each renewal date the asset and obligation are equal. This would eliminate a company's ability to generate accounting gains through a decision to not renew a lease.
- Third, the Boards could reconsider the element of the right-of-use model that treats the asset and obligation as separate and distinct components and allow the lease contract to be respected in total by having the asset and obligation amortize in lock step over the life of the lease.

We believe that the third alternative is preferable with the second alternative being acceptable.

6. Lessee incremental borrowing rate when options are included in lease term

For a lease with a renewal option at fair market rates, the renewal rental payments will be based on market conditions at the time the renewal option is exercised. The renewal rental payments will be based on the underlying asset value and the lessee's credit risk at the time the renewal option is exercised. If a lessee uses its incremental borrowing rate to discount its expected lease payments and includes the renewal option in the term of the lease, it will be using a discount rate that may not reflect market conditions at the time the renewal option is exercised. While this may be an intended consequence of the ED guidance, it does create a practical inconsistency between a renewal option at market rates and a lessee discount rate based upon earlier market conditions, and would not reflect a lessee discount rate that is based on market conditions at the time the renewal option is exercised.

If the Boards decide to include renewal options in the lease term, we propose that a lessee should remeasure its right-of-use asset and lease liability based on the lessee's incremental borrowing rate at the time of the exercise of the renewal option.

7. Changes to the carrying value of lessee's right-of-use asset

We believe guidance should be provided on how a right-of-use asset, would be amortized after recording changes to the carrying value of the right-of-use asset. For example, the ED may indicate

that a lessee should amortize the adjusted right-of-use asset using the same method used before the adjustment.

8. Subsequent measurement of performance obligation by lessors

In the BC paragraph 100, the Boards indicate that a lessor satisfies its performance obligation on a continuous basis. In ED paragraph 38(a), the Boards identify output methods as a means of measuring a lessor's satisfaction of performance obligations. An output method is not consistent with a continuous satisfaction concept. We recommend that the BC be amended to clarify that continuous satisfaction or output methods are appropriate methods to measure satisfaction of a lessor's performance obligation.

9. Remeasurement of a lessor's performance obligation

The Boards should provide guidance on how to remeasure or reassess a lessor's performance obligation when there is an impairment of a lease receivable or underlying asset under the performance obligation model. We propose that when a lessor impairs a lease receivable due to reductions in expected future lease payments, a lessor should reduce its remaining performance obligation correspondingly. By doing so, a lessor will more appropriately match a reduction in the consideration from a lessee with a reduction in future revenue to be recognized.

10. Performance obligations for lessors – warranty / asset retirement obligation

In our industry, lessors normally provide a warranty to lessees that may be a pass through of the warranty provided by the manufacturer. The Boards have provided guidance on warranty matters in the revenue recognition project but have not done so in the ED. We believe such guidance is appropriate for the new lease accounting standard.

Similarly, lessors and lessees may have contractual obligations in a lease relating to the eventual retirement of the asset. Current accounting guidance exists for asset retirement obligations for owned assets. However, guidance for lessors and lessees in the ED relating to asset retirement obligations in a lease contract is also appropriate.

11. Reliable estimation by lessors

We believe that a lessor should be able to consider whether amounts may or may not be reliably estimated as a factor in determining the present value of lease payments. A lessor should consider contractual and non-contractual factors to assess future lease payments. We also recommend that a lessor should estimate the future lease payments on a higher threshold than a "more likely than not" basis.

12. Presentation of residual asset

The Boards should consider whether presenting residual assets as part of property, plant and equipment is appropriate. A residual asset is considered an investment asset by lessors. If the residual asset is presented as part of property, plant and equipment, this implies that the residual asset

is used to support the lessor's business operations. Since the lessor absorbs the risk in the changes in value of the residual asset, the lessor views this asset as an investment that is expected to change in value during the term of a lease as opposed to an asset that will be depreciated based on usage or the passage of time.

13. Measuring residual assets at fair value

The guidance provides that at initial application the residual asset would be recognized at fair value. The Boards indicate that the fair value may not be available for leases currently classified as finance leases. Under current lease accounting guidance for finance leases, lessors measure residual assets at fair value. Since such guidance has been in place for years, lessors have the wherewithal to measure the fair value of residual assets.

The guidance for measuring residual assets at fair value at transition differs from other initial and subsequent measurement guidance, which provides that residual assets will be valued at an allocated amount. We believe that the guidance relating to the residual asset values should be consistent. The Boards should consider revising the guidance for initial and subsequent measurement to allow lessors the option of measuring residual assets at allocated cost or fair value.

14. Appendix A – Defined Terms

a. Contingent rentals

We believe using “arise” instead of “increase or decrease” would improve this definition.

b. Date of commencement of lease

The second sentence should be replaced with the following sentence: “For example, the date when the lessor conveys or delivers the underlying asset to the lessee and the lessee accepts the asset.”

c. Lease payments

In order to make this definition more consistent with current practice and the proposed new lease accounting guidance, we recommend the following definition: “Payments arising under a lease contract, including fixed rentals and rents subject to uncertainty, including renewal rents, contingent rentals, amounts payable under residual value guarantees and termination penalties.”

d. Lessor

This definition should mirror the lessee definition. We recommend the following definition: “An entity that enters into a contract to receive consideration from another entity for providing the right to use an asset.”

e. Lessee's incremental borrowing rate

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Based on our earlier comment on the lessee's incremental borrowing rate when renewal options at fair market value rentals are included in the lease term, we believe this definition should be revised to indicate that the term includes consideration of options to terminate or renew the lease.

f. Rate the lessor charges the lessee

A lessor establishes the rate it charges a lessee by factoring in the credit risk of the lessee and the expected value of the residual asset. As a result, the rate as defined here could be different than the actual rate charged by a lessor. The definition should be modified to include the expected fair value of the residual asset at the end of a lease. Alternatively, the definition should specifically indicate that this rate is not the same as the economic rate charged by the lessor.

g. Residual asset

A residual asset also exists for leases that are reported using the performance obligation approach, even though it is not separately recognized. This definition could be improved by indicating that a residual asset does not exist under the performance obligation approach.

Non-Public Entities

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Answer

We do not provide an answer to this question, as AWG's members are public companies.

We would be pleased to discuss these comments further with the Boards and their staff. We appreciate the Boards' acceptance of our request to participate in the Roundtable meeting on 6 January 2011 in Norwalk.

Respectfully,



Jeffrey Wool
Secretary and General Counsel
Aviation Working Group