AIR CANADA

September 12, 2013

IFRS Foundation / IASB
30 Cannon Street
London, EC4M 6XH
United Kingdom
Via email

RE: Comments on Exposure Draft on Leases

Air Canada appreciates the opportunity to comment on the Leases exposure draft dated May 2013. Air Canada is Canada's largest domestic and international airline serving more than 175 destinations on five continents. Canada's flag carrier is among the 20 largest airlines in the world and in 2012 served close to 35 million customers. Leases are prevalent in the airline industry and are an important part of the overall capitalization of the airlines. As such, the lease accounting standard impacts a significant component of the expenses, assets and liabilities of Air Canada.

We generally agree with the core principle of the proposal. We agree that an entity should recognize its assets and liabilities related to leases. We believe this core principle is generally able to be applied consistently across all types of leases and industries, with the cost and complexity of allowing any exceptions to the one accounting model outweighing any perceived benefits.

We believe it is important to ensure that any revisions to the lease accounting standard result in a revised standard that is consistently applied by all preparers, minimizes the requirements to make subjective assessments and is straightforward for the users of financial statements to understand. If these principles were achieved, the revised standard would require a reasonable investment in time and resources to implement and maintain going forward. With the dual accounting model as proposed, we have concerns regarding the cost and time required to amend systems and processes to reflect the proposed accounting and disclosures.

While the current accounting standard on leases may have certain shortcomings, we believe users of financial statements are provided with the material information regarding an entity's obligations, future commitments and material risks related to leases. Revisions to the standard should try to avoid providing too complex an accounting model and too much disclosure regarding leases which would adversely impact both the cost benefit of the revised standard and the users' understanding of its impacts.

Enclosed we provide our detailed comments on the proposals. Consistent with the points above, the overriding comment is to abolish the dual accounting model and amend the proposals to provide for one accounting model based on the Type A lease accounting model.

If you would like to discuss any of our comments, please contact Jeff Blakeston (jeff.blakeston@aircanada.ca) or myself.

Yours sincerely,

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Question 2 – Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response

We have a number of concerns regarding the proposals related to lessee accounting.

The dual accounting model for property and non-property leases (Type A & B) adds tremendous complexity to lease accounting due to the amortization method on Type B assets, the separation of disclosure requirements for Type A & B lease amounts and the number of subjective assessments required. There is little fundamental economic difference in the nature of a property or non-property lease in terms of how the lease payments need to compensate the lessor for both a financing cost as well as for the consumption of the underlying asset.

The amortization of the right-of-use asset under Type B leases has no basis in the conceptual framework. Users of financial statements will not understand why amortization on the right-of-use asset increases in later years, which is typically contrary to the benefits derived from property and equipment as maintenance and betterment costs increase as the asset ages.

In addition to the complexity to users of financial statements, existing financial systems are not equipped to systematically calculate the amortization method as proposed for Type B leases. Expensive system modifications would be required or, alternatively, reporting entities may resort to spreadsheet approaches, which can be inefficient and lack automated system controls.

The presentation of Type A and Type B right-of-use asset and lease liability amounts separately will add unnecessary complexity and detail to the financial statements. As noted above, we believe there is little economic difference between a Type A & Type B lease and as such we question what additional information is obtained by separately presenting such amounts on the balance sheet.

The impairment model on right-of-use asset for Type B leases is flawed as the amortization, and therefore carrying value, may not be indicative of the pattern of economic use of the right-of-use asset, which may create impairment situations by virtue of an amortization that is not indicative of the underlying economic use of the asset.

The suggested alternative to solve the concerns raised above would be to amend the proposals to provide for one accounting model to be consistently applied to all leases, except for short term leases, with such model being consistent with the Type A lease accounting model as proposed.

Question 4 – Classification of a lease

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response

While it may be the case that certain leases of property consume significantly less, if any, of the economic value of the property over the lease term, the accounting for Type B leases as proposed does not provide any additional informational value to the users of financial statements to convey this concept. The lessor's assumptions regarding what portion of the asset is consumed is built into the lease payments and therefore different accounting for property versus equipment is not providing additional information value versus what is implicit in the lease payments. Regardless of the amount of the economic life of the asset consumed or whether the lease relates to property or equipment, the lease accounting should reflect the cost to the entity over the term of the lease related to the right-of-use asset.

Based on the views expressed in the preceding paragraph, we believe there is unnecessary complexity in the proposed standard related to the lease classification test between total economic life for Type A and remaining economic life for Type B leases. As noted under our response to Question 2, having one classification model applied consistently for all leases would remove this unnecessary complexity without compromising the information content of the financial statements.

Question 5 - Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Response

In general, we agree with the proposals regarding lease term with the exception of the requirements related to certain types of reassessments. Reassessment of the lease liability as required under paragraph 44 adds a significant reporting and controls burden to reassess contract, asset, entity or market based factors that would impact the term of the lease. Certain factors and considerations will be subjective and subject to interpretation and differing treatment by reporting entities. For example, an entity could be required to assess how important a piece of equipment is to its operations in order to make an assessment of whether it will exercise a lease extension option. These types of assessments could change from period to period depending on the economic environment in which the entity operates and management's assessment thereof. Requiring such assessments may impair the representational faithfulness of the financial statements.

Based on the views expressed in the preceding paragraph, we believe that a reassessment of the lease liability should not include a requirement to reassess a change in relevant factors as described in paragraph B6.

Question 8 - Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognized in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Response

Consistent with the responses above, the dual accounting model creates an additional layer of disclosure requirements that will be a burden on systems and resources and provide limited value to the users of financial statements. In addition, of particular concern is the requirement in paragraph 64 to perform a reconciliation of the lease liability. This requirement is not required in IFRS7 as it relates to disclosures on other financial liabilities and as such, we believe paragraph 64 should be removed. Disclosures related to the right-of-use asset and the lease liability should be consistent with disclosures required under IAS16 and IFRS 7, respectively.

Other Matters

Foreign exchange volatility

In the airline industry, aircraft leases are typically denominated in U.S. dollars, which may not be the functional currency of the reporting entity. Under the proposal, the lease liability would be treated as a financial instrument and would be subject to foreign exchange adjustments, which could create significant income statement volatility. This income statement volatility due to foreign exchange rate changes is not necessarily indicative of the economic cost of the lease over the term of the lease. An alternative approach could be considered to include the foreign exchange remeasurement as an adjustment to the right-of-use asset, similar to how other remeasurements of the lease liability are treated under paragraph 43. Disclosure of the maturity analysis of the lease liability at current period foreign exchange rates under paragraph 67 provides useful information to users of the financial statements without adding the income statement volatility.

Component accounting for the right-of-use asset

Under IFRS, Air Canada has adopted an accounting policy whereby aircraft and flight equipment are componentized into airframe, engine, and cabin interior equipment and modifications. Major maintenance events on certain of these components are capitalized and amortized over the average expected life between major maintenance events. This accounting policy applies to owned equipment as well as equipment under finance leases.

Under the proposals, it is unclear whether the accounting policy above would be applicable to the right-of-use asset. We believe that the component accounting model as outlined above should be applicable to the right-of-use asset, as the concepts of a betterment that will provide economic benefits beyond one year can be applied similarly to an owned asset and a right-of-use asset controlled by the entity over the term of the lease. Any new standard on leases should be clear on component accounting for the right-of-use asset.

Maintenance provisions

Under IFRS and based on guidance in IAS37, Air Canada has adopted an accounting policy whereby Maintenance and repair costs related to return conditions on aircraft leases are recorded over the term of the lease for the end of lease maintenance return condition obligations within the Corporation’s operating leases.

Under the proposals, it is unclear whether this type of contractual obligation within the lease should be considered within the scope of the proposals. We believe a position can be taken that such payments are within the scope of residual value guarantees (or alternatively as a variable lease payment) and could be included within the lease liability based on paragraph 39(d). We believe the current accounting model to record a provision over the term of the lease related to contractual obligations embedded within a lease related to the return condition of the asset should be applicable within any new lease standard however additional clarity on this topic would be helpful.