
**POSITION PAPER ON IASB / FASB
INTERNATIONAL LEASE ACCOUNTING PROJECT**

AVIATION WORKING GROUP

October 2008

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1. Introduction

This paper sets out the general position of the Aviation Working Group (**AWG**) on the IASB / FASB international lease accounting project (the **Project**). Our goal is to provide the IASB / FASB Boards (the **Boards**), their Secretariats, and the Project's international working group with detailed views and suggestions on how the new lease accounting standard (the **Standard**) should be developed and applied, in view of AWG's experience and practice in the aviation sector. AWG commends the IASB / FASB for the inclusive manner in which work has been undertaken to date.

AWG reserves the right to modify or supplement the positions stated in this paper as the Project develops, and consequently, these positions should be viewed as provisional. Nothing in this paper shall prejudice the right of any AWG member to express contrary views, though AWG intends to seek consistent input to the IASB / FASB regarding the Project, as applied to aircraft leasing.

AWG is a not-for-profit legal entity whose purpose is to '*contribute to the development and acceptance of policies, laws, regulations and rules that (i) facilitate advanced international aviation finance and leasing or (ii) address inefficiencies in aviation financing or leasing or that constrain these transactions*'. Co-chaired by Airbus and Boeing, AWG is comprised of the major aviation manufacturers and financial institutions, including most of the world's largest aviation leasing companies. More information about AWG, its members, and activities may be found at www.awg.aero.

Members of AWG manufacture virtually all of the world's large aircraft and engines, and lease a high percentage of them.

AWG has a specialized sub-group working on lease accounting issues, which is focused on the Project. Its purpose is to develop consensus recommendations for submission to, and discussion with, the IASB / FASB.

This paper presents the following key matters:

- Section 2 is an executive summary;
- Section 3 is a review of the fundamental differences between leasing and financing transactions;
- Sections 4 and 5 provide our comments on lessee accounting issues, including the right to use model, financing and lease transactions, contingent rental payments, options to extend or terminate a lease, return conditions and the obligation to return leased equipment;
- Section 6 provides our comments on certain income tax matters relating to leasing; and
- the Appendix sets out an example of a true lease of equipment, with two alternative lessee accounting treatments.

This paper assesses the Project from the vantage point of, and based on our experience with, leasing in the aviation sector and accounting practice relating thereto. While references herein to leases and equipment should be read as references to aviation leases and equipment, respectively, we are not seeking special rules applicable to aviation leasing.

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2. Executive summary

AWG, noting the efforts of the Boards to develop a new Standard based on a right to use model, supports:

- the efforts of the Boards to **reflect transaction economics** in that Standard;
- the Boards' recommendation **not to revise lessor accounting** for lease transactions; and
- the Boards' intention to **exclude** leasing matters from the **revenue recognition project**.

The current right to use model does not adequately recognize the fundamental differences between a lease that essentially conveys a right to use an asset for a limited period of time (a *true lease*) and a lease that is used to achieve an in-substance acquisition of an asset by the lessee (a *financing transaction*). This paper supports using different accounting approaches for these two types of transactions, and does so in a way that would align expense recognition for the lessee with revenue recognition of the lessor. AWG believes that the rent expense and the measurement for a right to use asset subsequent to its initial recognition should be accounted for differently in the case of a *true lease* and that of a *financing transaction*. In doing so, AWG believes that the economics of a true lease will be better captured and reported (see our suggested accounting treatment below).

AWG believes that the current accounting guidance for finance or capital leases does not require revision, and, thus, supports the proposition that the proposed right to use model should not lead to any significant changes in the current accounting guidance for such leases.

AWG therefore recommends that the Boards modify their proposal in the Project and the Standard to reflect the fundamental differences between a *true lease* and a *financing transaction*. Significant among these fundamental differences are the following. In a **true lease**:

- the lessee does not in-substance own the leased equipment, and the lessor retains the risks and rewards associated with ownership; and
- the lessor bears the risks and rewards of the residual value of the leased equipment.

Regarding lessee accounting and the Project, AWG recommends that:

- the Boards should recognize the differences between a financing transaction and a true lease;
- a lessee's lease expense should reflect the economics of a true lease, that is, the cost of the lease throughout its term, and should be recorded as rent expense using a straight line periodic average of the expected aggregate lease payments;
- the proposed right to use model should be limited to true leases;
- the proposed right to use model should be modified to distinguish between a true lease and a financing transaction, as regards the lease costs to be reported;
- the unit of account for a true lease should be the lease contract; and
- a lessee should account for a financing transaction in accordance with current accounting guidance for a finance or capital lease.

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AWG supports using a best estimate of contractual, non-contractual and other business factors to determine the term of a lease. AWG believes that the outcome of this best estimate should result in a lease term that is consistent with, and available under, the lease contract.

AWG supports using the best estimate of contingent lease payments to measure a lease obligation. AWG believes that contingent lease payments should include all lease payments for which a lessee is obligated, including those which are based on the usage of a leased asset.

A lessee should record an obligation for the return condition of lease equipment and the expected costs of that return.

For countries that require reporting for **income tax purposes** to follow financial reporting, changes in accounting for lease contracts may lead to changes in the economics of lease transactions.

3. Fundamental differences between a true lease and a financing transaction

3.1. Overview

In this paper, we use the term *true lease* to mean a lease in which a lessor, while providing a lessee with the right to use an asset during the lease term (subject to a lessee's performance under that lease), retains the substantial risks and benefits associated with that asset, including its residual value. This is in contrast to a *financing transaction*, effected through a lease whose purpose is to finance a lessee's in-substance acquisition of a leased asset.

There are fundamental economic differences between a true lease and a financing transaction. The most significant difference is that in a true lease transaction, a lessor (owner) is exposed to substantially all risks and rewards associated with owning a leased asset, including the redeployment and residual value risks, both of which represent substantial economic differences with a financing transaction.

For a financing transaction, AWG views the lessee's entitlement from the lease as that of an in-substance owner; in contrast, under a true lease we view the lessee's entitlement as that of a recipient of a service (the right to use an asset). The fundamental economic differences between these two types of lease justify the use of different accounting principles, as explained below.

AWG recognizes that the Boards addressed the differences between a finance (capital) lease and an operating lease in their deliberations prior to the issuance of FAS 13 and IAS 17. We believe that those differences remain today, and we reflect them in this paper by our distinction between a *true lease* and a *financing transaction*. We understand that the Boards have tentatively decided to require the recording of a lease asset and a lease liability for all leases. We also understand that the concept of bright-line tests to distinguish between a true lease and a financing transaction would not be appropriate given the principles-based approach taken in the Standard, that provides guidance on how to initially record a right to use asset and a lease obligation. We recommend that in the absence of a bright-line test, the Boards provide clear guidance, including indicators to consider whether a lease should be accounted for as a true lease or a financing transaction.

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3.2. True leases and financing transactions

The following table highlights the key characteristics of a true lease and a financing transaction effected through a lease as well as their fundamental differences:

True Lease	Financing Transaction (using a lease)
<ul style="list-style-type: none"> • A lessee receives a service pursuant to the lease. The service is the right to use the leased asset. The lessee does not have the significant rights and obligations relating to ownership of the leased equipment. 	<ul style="list-style-type: none"> • A lessee uses a lease to accomplish an in-substance purchase of the leased equipment.
<ul style="list-style-type: none"> • The lessor is providing equipment for rent to the lessee and does not expect the lessee to purchase the equipment at the end of the lease, other than at the fair market value of the equipment, if so agreed. 	<ul style="list-style-type: none"> • The lessor (lender) is providing funds to the lessee (borrower), on a secured basis, in order to finance the in-substance acquisition of the leased asset by the lessee.
<ul style="list-style-type: none"> • The lessor expects to have the leased equipment returned at the end of the lease for release to other lessees. This condition is common for equipment with long useful lives, such as aviation equipment. 	<ul style="list-style-type: none"> • The lessor does not expect to have the financed equipment returned by the lessee during or at the end of the lease term.
<ul style="list-style-type: none"> • The lessor remains the legal and economic owner, with a wide range of legal implications. 	<ul style="list-style-type: none"> • The lessor views its title to the equipment as security for its in-substance loan.
<ul style="list-style-type: none"> • The lessor expects to realize the tax benefits of ownership, and does not transfer such benefits to the lessee. 	<ul style="list-style-type: none"> • A lessor may realize the beneficial tax interest in certain jurisdictions, but this benefit is often transferred to the lessee through a rent pricing adjustment.
<ul style="list-style-type: none"> • The lessor considers the residual value, releasing and repossession risks of the equipment when assessing the terms of the underlying lease and, to a lesser extent, the credit risk of the lessee. 	<ul style="list-style-type: none"> • The lessor considers the credit risk of the lessee and the value of the equipment as security (during the term of the lease) and its realization when assessing the terms of the underlying lease.
<ul style="list-style-type: none"> • The lessor expects to realize a return on its investment from the lease payments as well as the future release and residual value of the equipment. The lessor bears the risk of, and benefits from, future leasing of the equipment following return of the equipment. 	<ul style="list-style-type: none"> • By virtue of its legal ownership, the lessor obtains a security interest in the equipment to minimize the risk of loss following non-payment by the lessee, but otherwise does not benefit from the residual interest in, or future use of, the leased equipment.
<ul style="list-style-type: none"> • The terms of the lease provide for rental payments and payments contingent upon usage of the equipment. A fair market value purchase option may be provided to the lessee at the end of the lease term. 	<ul style="list-style-type: none"> • The terms of the lease provide payments that allow for transfer of title to the lessee at the end of the lease term. A bargain purchase option may be provided to the lessee at the end of the lease.

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True Lease	Financing Transaction (using a lease)
<ul style="list-style-type: none"> • A lessor may fund a transaction with debt that matures over a period similar to or longer than the lease term. The lease rate will include a spread over the cost of funds that takes into account a return on the residual interest, the redeployment risks, and the tax benefits associated with owning the equipment. 	<ul style="list-style-type: none"> • A lessor will establish its yield on the lease based on a spread over the costs of funds used to finance the leased equipment without expecting any return on the residual interest in the leased equipment.

The accounting for a financing transaction should reflect the fact that its purpose is to finance a lessee's in-substance acquisition of the leased asset, and that it transfers to the lessee the substantial risks and rewards of ownership of a leased asset, including substantially all of its residual value. The accounting for a true lease should reflect the fact that its purpose is to provide usage of the equipment to a lessee for a limited period of time, and that the lessor is not transferring the significant risks or rewards of ownership of the equipment to the lessee.

4. Proposed right to use model for a true lease and a financing transaction

The Boards have identified the proposed right to use model as the most appropriate model to recognize and account for leases. AWG understands that the Boards intend to proceed with the proposed right to use model; however, as explained further in this paper, AWG believes that the right to use model should only apply to true leases, as modified in accordance with our suggested approach. For finance (capital) leases, AWG believes that current accounting guidance is appropriate and adopting the proposed right to use model is neither necessary nor desirable.

A basic concept in the proposed right to use model is the recognition of a right to use asset and a lease liability at the inception of a lease. While we do not believe that the proposed right to use model is appropriate for all lease transactions, we recognize that such is the Boards' intent. By recording an asset and a liability, all leases would be accounted for similarly. For the expense of a lease transaction, AWG strongly believes that a *true lease* should be accounted for differently than a *financing transaction*. AWG agrees that a *financing transaction* does represent an in-substance purchase of a leased asset. AWG strongly disagrees that a *true lease* be accounted for as an in-substance purchase of a leased asset.

We note that the application of the proposed right to use model leads to the recognition of a right to use asset and a lease liability. However, the subsequent measurement and accounting for a right to use asset, a lease liability and the costs of a *true lease* should recognize the fundamental differences between a *true lease* and a *financing transaction*. Since a true lease is not an in-substance purchase, AWG believes that the costs relating to a true lease should be recognized and accounted for using the entire lease as the unit of account:

- the rent expense should reflect the economics of the lease contract and should be recognized on a systematic basis throughout the term of the lease; and
- the lessee should report rent expense each period determined by the straight line average of the expected aggregate lease payments during the term of the lease contract.

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5. Lessee accounting

AWG understands that the Boards intend to proceed with the proposed right to use model, which has much in common with the current accounting guidance for finance and capital leases, including the requirement for the initial recognition of the right to use asset and lease liability. We also understand that such treatment would not be difficult to implement, and would be consistent with the credit rating agencies' practice of adjusting an airline's financial statements in order to reflect current operating lease transactions. Such practice includes adjusting a lessee's statement of financial position to add leased assets and lease liabilities. In addition, such practice includes allocating lease rental expense to amortization and interest expense, while retaining the total amount of rent expense in connection with operating leases. Lessees usually recognize such expense on a straight line basis during the term of a lease.

5.1. Unit of account

As a threshold matter, the Project should address the unit of account issue. The appropriate *unit of account* for true leases should be the entire lease contract. A lessor and a lessee are parties to that contract. The rights available to, and the obligations imposed on, the parties in a lease are inextricably linked by the lease documents. Therefore, the right to use asset and the lease liability which would be recorded based on the Boards' tentative position are linked in the same manner. The lessee's incurrence of, and payments for, the lease liability provide the lessee with the right to use the leased asset – in other words, a right to use asset is not available to a lessee without incurring a lease liability. In a true lease, a lessee's subsequent measurement of a right to use asset and lease liability are very closely linked: the combined measurement of these elements should have the derived cost of the true lease recognized to income reflecting the economic substance of the lease. The example presented in the Appendix indicates how this approach would be implemented.

A default by a lessee impacts the rights of a lessor: a predictable rental stream is replaced by a compensatory damage payment, coupled with return of the asset (which will be redeployed by lessor, thus mitigating damages). A lessee's use rights are conditioned upon its performance. In addition, such use rights are often contingent on performance by a lessor - the lessee's right to use may be terminated upon a lessor's insolvency, since many legal systems view leases as terminable executory contracts. These rights and obligations are generally present in leases for aviation equipment, and may also be similar to the rights and obligations under leases of non-aviation equipment.

A lease should be measured and reported in a manner that reflects the non-separable nature of rights and obligations.

One could reasonably argue that the leased assets and liabilities should be netted in a lessee's statement of financial position. We believe that the unit of account for a lease transaction should be a lease contract and that the accounting for a lease contract should encompass all aspects of that contract. Presenting a right to use asset and a lease liability on a net basis in the statement of financial position has merit even without a right of offset, absent a lease default or termination and the satisfaction of other conditions. That said, we understand that since one of the objectives of the Boards is to reflect lease-related assets and liabilities in a lessee's statement of financial position, the Boards' current intent is to report lease-related assets and liabilities separately.

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5.2. Nature of Asset (PP&E) – True Lease

In discussing the proposed right to use model, the Boards have indicated that a lease creates an asset for the lessee that is neither equivalent to owning the asset itself nor an intangible asset. For a true lease, AWG supports the position that a right to use asset is not the equivalent of owned property, plant or equipment (PP&E) or an intangible asset. A lessee has a contractual right to receive a service from the lessor consisting of the usage of the leased equipment during the term of the lease contract. The lessee controls the usage of the leased equipment and would normally realize an economic benefit from the use of the leased equipment. AWG does not believe that this right to use the leased asset is equivalent to owning the asset, and a lessee should not report a right to use asset as an owned asset in its financial statements.

AWG does **not** support the nature of asset (PP&E) model to account for a lessee's right to use the leased asset created by a true lease, since the nature of asset (PP&E) model assumes that the lessee has substantially purchased and owns the equipment. As stated earlier, in a true lease, the lessee does not assume substantially all risks and rewards normally associated with ownership of a leased asset; those ownership risks and rewards remain with the lessor. If a lessee were to report a right to use leased assets using the nature of asset (PP&E) model, **there would be a lack of transparency in the financial reporting by a lessee.** There would not be visibility between assets that are owned and assets that are leased. We believe that the transparency could be enhanced by requiring a lessee to separately report and disclose owned versus leased assets. Accordingly, the accounting for a *true lease* should recognize the fundamental differences between a *true lease* and a *financing transaction*.

5.3. Nature of Asset - Financing Transaction

AWG agrees that a financing transaction represents an in-substance purchase of a leased asset and therefore, the nature of asset model (PP&E) should be applicable to the accounting and reporting for an in-substance purchased asset.

AWG believes that the application of the current finance lease model as currently contemplated by the Boards is appropriate for a financing transaction.

5.4. True Leases – Linked Right and Obligation

As noted, we believe that the appropriate unit of account for true leases should be the entire lease contract. Generally, all elements contained in a true lease are closely related to the lease of the asset. As indicated in paragraph 5.1 above, the rights available to, and the obligations imposed on, the parties to a true lease contract are inextricably linked.

Assuming that the right to use a leased asset and the corresponding lease obligation meet the definitions of asset and liability under the conceptual framework document, we understand that separate recognition of these components in the balance sheet is intended. We believe, however, that since a lessee's right to use an asset and lease liability are linked, the initial and subsequent measurement of the related asset and liability should be linked as well. That would achieve an expense recognition which reflects the substance of the arrangement (the provision of a service, the right to use the asset), by retaining the current concept of recognition based on the time use pattern of the asset, even with separate recognition of the assets and current and non-current liabilities on the balance sheet.

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AWG strongly believes that a lessee should record the total cost relating to a *true lease* in periodic amounts that recognizes the economic cost of the services being provided through the lease, which is the right to use an asset. The right to use an asset is a benefit that is consumed in a linear manner, i.e. the right to use the leased asset provides an even benefit to the lessee during the lease period. Accordingly, the related cost should reflect this economic reality and be recognized using the straight line average of the expected lease payments method. Our suggested approach to segregating between the two types of leases is based on the fundamental economic differences between a true lease and a financing transaction. Recognizing rent expense based on the economic cost of a lease would be logical. The resulting accounting would differ from that of finance (capital) leases, but AWG believes this to be justified by the reasons outlined above.

In addition to the economic rationale for our suggested accounting treatment, adopting AWG's proposal for the recognition of rent expense for a true lease would align the accounting by a lessee for the rent expense with the accounting by a lessor for the rent revenue, thus eliminating one of the drawbacks of having inconsistent accounting rules relating to expense and revenue recognition for the lessee and the lessor, respectively.

5.5. Appendix – Example of Different Lessee Accounting Treatments in True Lease

In the Appendix to this paper, we present an example of a true lease, with two possible lessee accounting treatments:

- Treatment A shows the right to use asset following the nature of asset (PP&E) model, which AWG does not support; and
- Treatment B shows our preferred way of recognizing the cost of a true lease - rental expense should be reported based on the straight line average of lease payments over the term of the lease.

In each case, we have included the initial and recurring journal entries and the financial statements of the lessee.

5.6. Contingent lease payments, including those based on usage

The Boards have concluded that contingent lease payments should be considered as part of the initial measurement of a lessee's right to use asset and lease obligation. A lessee would make its best estimate of the contingent rental payments expected to be made to a lessor. AWG supports the position that the best estimate of contingent rental payments should be included in the initial measurement of a lessee's lease obligation and right to use asset. The use of a best estimate of payments contractually required under the lease, if estimates proved to be right, creates an even cost over the lease term and will best reflect the economics negotiated through the lease. Initial estimates should be adjusted as the lease progresses. Subsequent adjustments that reflect the difference between an estimated and an actual lease payment should be recorded as rent expense in the period when the new pattern of lease payment is known and measurable.

The Boards' staffs have noted in agenda papers that if a best estimate of contingent rental payments is included in the new Standard, the Project will be delayed beyond 2011. AWG's view is that deriving a best estimate should not be considered as a new concept that would extend the time needed for completion of the Project. In leases where contingent rental payments are included, a lessor and a lessee have an expectation that a certain level of contingent rental payments will be made. Otherwise, there would not be a reason to include contingent rental

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payments in the terms of a lease contract. Since lessors and lessees are accustomed to considering expected contingent rental payments in their economic analysis of a lease transaction, including a best estimate of contingent rental payments should not represent a significant change to current lessor and lessee practice.

Leases in the aviation industry frequently impose an obligation on a lessee to pay a lessor contingent rental payments based on the usage of leased equipment. Typically, this obligation exists with true leases and may also exist in financing transactions. A lessee is obligated to pay a lessor a periodic amount based on the hours or cycles. When a lessee accepts delivery of leased aviation equipment, it will normally use such equipment for its scheduled flights. A lessee is able to estimate the amount of usage based on its expected deployment of that equipment. As a result, a lessee would be able to determine a best estimate of the contingent rental payments due to a lessor for usage of leased aviation equipment at initial and subsequent measurement of a lease obligation.

5.7. Option to extend or terminate a lease

The Boards have decided to include options to extend or terminate a lease in the measurement of a right to use asset and a lease obligation, based on the best estimate of the expected lease term. The Boards have been asked to consider contractual factors, non-contractual factors and business factors when determining the lease term. AWG supports the position that these factors should be considered on a best estimate basis for this purpose, and that the lessee's conclusion on the expected lease term should be dispositive. The best estimate of the lease term should be consistent with a lease term that is available under the lease contract.

AWG also believes that:

- the guidance relating to the probability threshold in FAS 13 (“reasonably assured”) and IAS 17 (“reasonably certain”) is significantly different from the proposed best estimate approach;
- the change to a best estimate approach may more significantly impact options to extend a lease than options to terminate a lease;
- using a best estimate approach to determine the term will result in a significant change from current accounting practice but will result in harmonization of international lease accounting; and
- the Boards should provide guidance about the factors that should be considered when applying a best estimate approach to determine a lease term.

The Boards have indicated that lessors' accounting for leases would be excluded from the scope of the Project. We observe, however, that applying a best estimate approach to determine the term of a lease may change the accounting for existing leases by lessors as well as lessees. Therefore, assuming the Boards approve the use of a best estimate approach in the new Standard, the Boards should address whether this change to lessee accounting also applies to lessors.

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5.8. Return condition

Aviation lease contracts include an obligation for a lessee to return the equipment in a minimum return condition. The lessee accepts delivery of the equipment at inception in a certain physical condition, including, in the case of an aircraft, a measurement of the number of flight hours or cycles that remain until the next scheduled major maintenance event. At the beginning of a lease, the lessee may have an obligation for the return condition of the leased aviation equipment if the delivery condition is less than the required return condition.

Generally in aviation equipment lease contracts, the lessee assumes an obligation to return leased equipment to a contractually required minimum condition at the termination of the lease contract. In addition, the lessee must maintain leased aviation equipment in accordance with civil aviation regulations. Since an obligation exists in this situation, the lessee should recognize a liability for the estimated cost of the major maintenance work to return the leased equipment to its contractually required return condition, at the inception of the lease and during the term of the lease. The event that creates an obligation for the lessee is the maintenance condition of the leased equipment.

5.9. Obligation to return leased equipment

At the beginning of a lease contract, the lessee incurs the future obligation to return leased aviation equipment on expiry or earlier termination of the lease. This return obligation should be recorded as a provision (a liability) at its estimated cost. This obligation should be measured as part of a lessee's liability at lease inception. The location for the return will either be prescribed in the lease contract or be mutually agreed subsequently by lessee and lessor.

During the term of a lease contract, the lessee should adjust the liability for changes in the expected costs for the physical return of the equipment to the extent that the estimated costs exceed the initial carrying value of the liability.

At the inception of the lease and during the initial period of a lease, the expected costs to return leased aviation equipment may not be reliably estimated with any reasonable degree of precision. In addition, the lessee may not be able to reliably predict a return location. In addition, the size of the discounted future costs to return leased aviation equipment may not be significant in comparison to the lessee's lease liability for a lease contract. In such circumstances, AWG recommends that the lessee should not be required to record a provision (a liability) for the expected costs to return leased aviation equipment until there is a reasonable basis for the measurement.

6. Income tax matters

6.1. General matters

The Boards have indicated that accounting for income tax matters related to leases is outside the scope of the Project, since they consider that current income tax accounting standards adequately address this matter, and that the Boards should not be providing guidance for income tax accounting in each individual country. AWG concurs.

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However, income tax considerations are a critical economic component in leasing transactions. AWG recommends that the Boards consider the effect of the proposed leasing standard on this critical component to leasing transactions.

For certain countries, the financial accounting rules are the basis for how an entity reports its taxable income to calculate its current income tax liability. For these countries, there may be no differences, or minimal temporary differences, between financial and income tax reporting relating to leasing transactions. If the Boards were to decide that the proposed right to use model is the appropriate model to use for lessees, the Standard would affect the tax economics of lease transactions.

6.2. Lessees

Under the proposed right to use model a lessee would record (i) an asset that would be amortized over the term of the lease, and (ii) a lease liability under IAS 17 rules for finance leases, irrespective of the lease classification. We understand that under the proposed model, the expenses recorded by a lessee relating to a lease would be composed of amortization expense for the right to use the asset and interest expense, as compared to rental expense under the current accounting model for operating leases.

The periods when a lessee would record amortization and interest expense under the proposed right to use model will not be the same as the rental expense for an operating lease under the current accounting model. In countries where a lessee does not have temporary differences for the reporting of its operating lease transactions, a lessee will see the amount of its taxable income changed compared to the current accounting model.

As a result, implementation of the proposed right to use model will change the cash flows for a leasing transaction for a number of lessees by changing their current income tax liability. The Boards should consider this economic consequence in reaching its view on the expense pattern recognition for lessees. As contemplated, the proposed right to use model may alter the total tax cash flows of certain leasing transactions.

We do not believe that the Boards expect that implementation of new lease accounting rules should lead to a change in the economics of leasing transactions. However, since there are countries where there would likely be a change in the economics due to changes in the cash flows relating to income tax payments for leasing transactions, adoption of the Standard may lead to the unintended consequence of a change in the economics of a leasing transaction. If the intention of the Boards is to change the economics of certain leasing transactions by changing the tax cash flows during a lease, the Boards should acknowledge that the Standard may result in a change to the tax cash flows for certain leases.

The unintended consequences would be avoided if our suggested accounting for lease expense by a lessee in a true lease is retained.

APPENDIX – LESSEE ACCOUNTING TREATMENT FOR TRUE LEASE

Our example consists of an aircraft lease having the following basic economics:

1. Lease of aircraft for 10 years under a true lease.
2. Lessor cost and fair value of aircraft at inception of lease - \$100 million.
3. Lessor residual value at end of lease - \$50 million.
4. Monthly lease rental payment - \$1 million.
5. Lessee's incremental pre-tax borrowing rate – 8% per year.
6. Net present value of lease liability at inception - \$82.421 million, calculated from:
 - (a) lease payments of \$1 million monthly for 120 months;
 - (b) discounted at 8% per year.

In each case, dollar amounts are stated in millions.

We set out below two possible lessee accounting treatments – Treatment A, which adopts the nature of asset (PP&E) model for the proposed right to use model, and Treatment B, which requires the rental expense to be reported based on the straight line average of lease payments over the term of the lease.

As explained in paragraph 5.2 of this paper, AWG strongly believes that for a true lease, the nature of asset (PP&E) model in the proposed right to use model (Treatment A) is inappropriate, and hence AWG supports Treatment B, for the reasons also explained in paragraph 5.2.

Accounting Treatment A – Right to use model - nature of asset approach

Under this treatment, the right to use leased aircraft asset at inception (\$82.421 million, based on the net present value of lease liability at inception) is amortized on a straight line basis to zero value over 120 months.

Lessee Financial Statements											
Example A - Right to use model using nature of asset approach											
Statement of Financial Position - Selected Accounts											
At December 31 of Year											
	0	1	2	3	4	5	6	7	8	9	10
Right to use asset											
Cost	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4
Accumulated amortization	-	(8.2)	(16.5)	(24.7)	(33.0)	(41.2)	(49.5)	(57.7)	(66.0)	(74.2)	(82.4)
Net cost	<u>\$ 82.4</u>	<u>\$ 74.2</u>	<u>\$ 65.9</u>	<u>\$ 57.7</u>	<u>\$ 49.4</u>	<u>\$ 41.2</u>	<u>\$ 32.9</u>	<u>\$ 24.7</u>	<u>\$ 16.4</u>	<u>\$ 8.2</u>	<u>\$ -</u>
Lease liability	\$ 82.4	\$ 76.8	\$ 70.7	\$ 64.2	\$ 57.0	\$ 49.3	\$ 41.0	\$ 31.9	\$ 22.1	\$ 11.5	\$ -
Statement of Operating Results - Selected Accounts											
Year ended December 31											
	Total	1	2	3	4	5	6	7	8	9	10
Expense:											
Amortization	\$ 82.4	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2	\$ 8.2
Interest	37.6	6.4	5.9	5.4	4.9	4.3	3.6	2.9	2.2	1.4	0.5
Total expense	<u>\$ 120.0</u>	<u>\$ 14.6</u>	<u>\$ 14.1</u>	<u>\$ 13.6</u>	<u>\$ 13.1</u>	<u>\$ 12.5</u>	<u>\$ 11.8</u>	<u>\$ 11.1</u>	<u>\$ 10.4</u>	<u>\$ 9.6</u>	<u>\$ 8.7</u>
Journal Entries											
	Debit	Credit									
Initial measurement											
Right to use asset		\$ 82.4									
Lease liability		\$ 82.4									
To record right to use asset and lease liability upon delivery of aircraft to lessee											
Subsequent measurement - monthly (month 1 data used for example)											
Lease liability		\$ 0.5									
Interest expense		\$ 0.5									
Cash			\$ 1.0								
To record monthly lease payment											
Amortization expense		\$ 0.4									
Accumulated amortization			\$ 0.4								
To record monthly amortization expense											

Accounting Treatment B – Right to use model – lease cost reported as rental expense

The right to use leased aircraft asset and lease liability at inception are \$82.421 million. Under this treatment, the asset and liability are amortized using methods that recognize that they are directly linked. The liability is amortized using a mortgage style where the payments are first applied for an interest component and then a principal component. The asset is amortized each year for the principal component. The rental expense is reported based on the straight line average of lease payments over the term of the lease.

Lessee Financial Statements											
Example B - Right to use model - Lease cost reported as rent expense											
Statement of Financial Position - Selected Accounts											
At December 31 of Year											
	0	1	2	3	4	5	6	7	8	9	10
Right to use asset											
Cost	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4	\$ 82.4
Accumulated amortization	-	(5.6)	(11.7)	(18.2)	(25.4)	(33.1)	(41.4)	(50.5)	(60.3)	(70.9)	(82.4)
Net cost	<u>\$ 82.4</u>	<u>\$ 76.8</u>	<u>\$ 70.7</u>	<u>\$ 64.2</u>	<u>\$ 57.0</u>	<u>\$ 49.3</u>	<u>\$ 41.0</u>	<u>\$ 31.9</u>	<u>\$ 22.1</u>	<u>\$ 11.5</u>	<u>\$ -</u>
Lease liability	\$ 82.4	\$ 76.8	\$ 70.7	\$ 64.2	\$ 57.0	\$ 49.3	\$ 41.0	\$ 31.9	\$ 22.1	\$ 11.5	\$ -
Statement of Operating Results - Selected Accounts											
Year ended December 31											
	Total	1	2	3	4	5	6	7	8	9	10
Rental expense	<u>\$ 120.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>	<u>\$ 12.0</u>
Journal Entries											
	Debit		Credit								
Initial measurement											
Right to use asset				\$ 82.4							
Lease liability					\$ 82.4						
To record right to use asset and lease liability upon delivery of aircraft to lessee											
Subsequent measurement - monthly (month 1 data used for example)											
Lease liability				\$ 0.5							
Rental expense				\$ 1.0							
Accumulated amortization					\$ 0.5						
Cash					\$ 1.0						
To record monthly lease payment, reduction of lease liability and accumulated amortization											