POSITION PAPER ON IASB / FASB INTERNATIONAL LEASE ACCOUNTING PROJECT

RESPONSES TO QUESTIONS ASKED IN PRELIMINARY VIEW DOCUMENT ON LEASE ACCOUNTING

INTERNATIONAL AIR TRANSPORT ASSOCIATION

and

AVIATION WORKING GROUP

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I. INTRODUCTION

This paper provides the IASB / FASB Boards (the ***Boards***) and their Secretariats with detailed views, responses and suggestions from the International Air Transport Association (***IATA***) and Aviation Working Group (***AWG***) relating to the Boards' lease accounting project (the ***Project***), and in particular on questions raised by the Boards in their discussion paper / preliminary view document issued 19 March 2009 (the ***Discussion Paper***).

We reserve the right to modify or supplement the positions stated in this paper as the Project develops. Consequently, these positions should be viewed as provisional. Nothing in this paper shall prejudice the right of any IATA or AWG member to express contrary views, though we intend to seek consistent input to the Boards regarding the Project.

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 comprises 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.

IATA is an international trade body that represents 230 airlines comprising 93% of scheduled international air traffic. More information about IATA, its members, and activities may be found at www.iata.org.

IATA and AWG members are users and preparers of financial statements.

AWG and IATA have specialized sub-groups that work on accounting issues. One of their main purposes is to develop consensus recommendations for submission to, and discussion with, the Boards on the Project.

This paper assesses the Project from our experience with leases in the aviation sector, and related accounting practice. However, we are not seeking special rules applicable to the aviation industry.

We would be pleased to meet with the Boards' members and staff to fully explain our views.

II. EXECUTIVE SUMMARY

We support the efforts of the Boards to reflect transaction economics in the new lease accounting standard (the ***Standard***). However, we believe that the following points need to be reflected in the Standard:

(1) **Lease Accounting Considerations:** Overall considerations on lease accounting, set out in Part III, should be taken into account in preparing the final Standard.

(2) **True Lease versus Financing Transaction:** The Standard as applied to lessees should be modified to reflect the fundamental differences between a true lease and a financing transaction. The Boards have not adequately assessed and addressed the fundamental economic, legal and tax differences between a true lease and a financing transaction. Nor have the Boards supported their conclusion that all leases should be reported using the right-of-use model. That is discussed in Part IV.

(3) **Lessor Accounting:** Lessor accounting should be excluded from the scope of the Project. The principal objective of the Project is to address off-balance sheet financing issues for lessees. That is achieved in the lessee portion of the Standard. Lessor accounting does not present similar issues, and, more broadly, is well recognized and viewed as satisfactory by the users of financial statements. Assuming the Project nevertheless includes lessor accounting, in Part V comments are provided to Approaches A and B.

(4) **Manufacturer Accounting:** The Boards should provide clear guidance on revenue recognition and lease accounting for a manufacturer when a lease is involved with the sale of a product. A manufacturer should be able to recognize revenue / profit on delivery of a new aircraft / engine when its customer enters into a lease contract for the delivered aircraft / engine. This issue is discussed in Part VI.

(5) **Ongoing Fair Value Measurement:** It is possible to measure a lease contract at inception using a discounted cash flow analysis as a proxy for a fair value measurement. However, it is not possible to subsequently measure an obligation to pay rentals or a right-of-use asset at fair value unless (a) the entire lease contract is the unit measured, and (b) the fair value measurement guidance is based upon an entry price. This issue is discussed in Part VII.

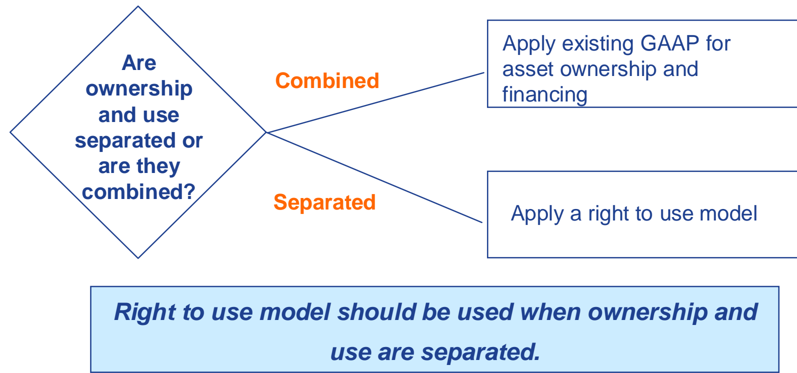
(6) **Harmonization of Guidelines for Impairment:** The Boards have added an impairment project to their joint agenda for financial instruments. In conjunction with the issuance of the new lease accounting Standard, the accounting guidelines for lease receivables and long-lived assets must be harmonized as well.

(7) **IASB / FASB Consensus:** A consensus position should be reached (on those issues on which IASB and FASB currently differ) before the issuance of the Exposure Draft document. This issue is discussed in Part VIII.

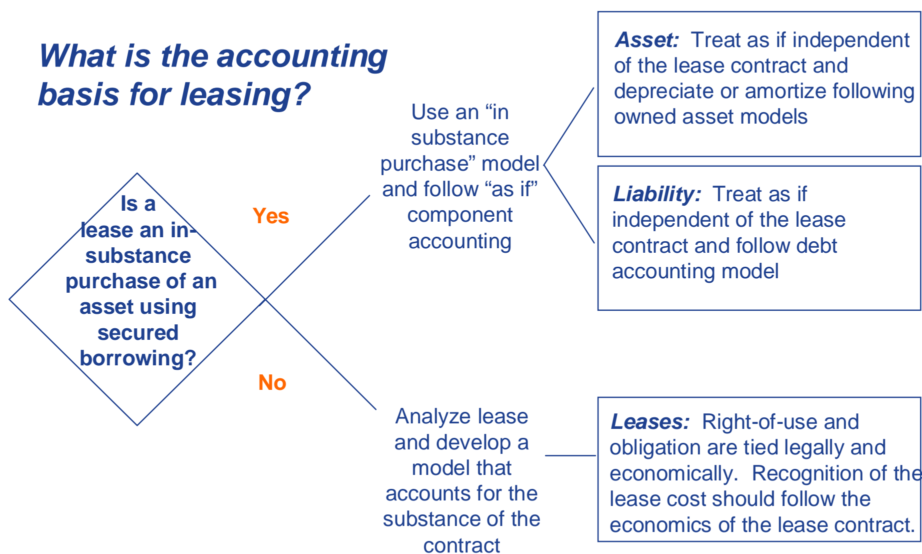
(8) **Performance Obligation:** Except for a financing transaction (where a lease is in substance a sale of the underlying asset), a lessor (a) transfers a service, and (b) does not transfer ownership of a leased asset. A lessor stands ready to perform the rental service during the term of a lease. Satisfaction of a performance obligation should be recognized evenly during the term of a lease. The Boards should distinguish between leasing and service contracts. These issues are discussed in Part IX.

III. LEASE ACCOUNTING CONSIDERATIONS

The scope of the Project needs to reflect the characteristics of a lease. This issue is illustrated below:

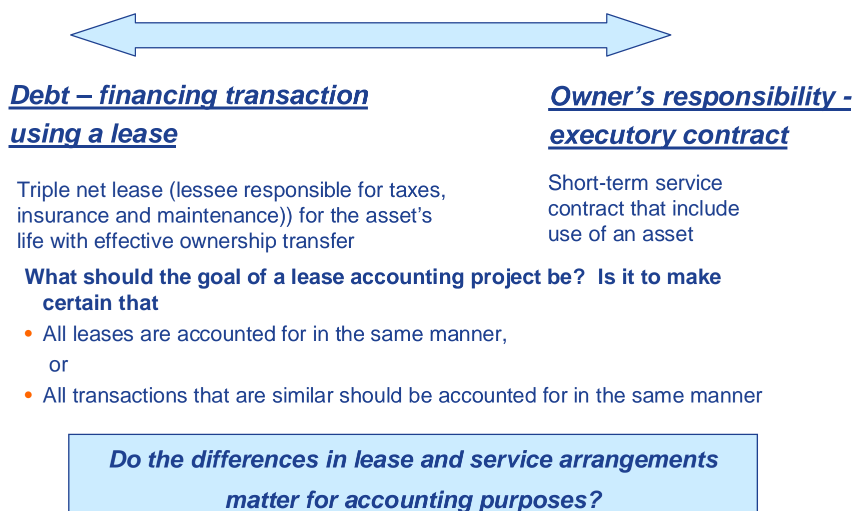


A leasing contract should be evaluated to determine the proper accounting model, as shown below:



The economic purpose of lease contracts ranges from purchases to short-term rentals, as shown below:

Leasing continuum



Lease accounting may be approached as shown below:

How should leases be approached one sided v. two sided test

Current literature

Right to use property for a stated period of time

- True leases
- Conditional sales agreements (loans)
- Certain embedded leases

Scope is currently a "one sided" / asymmetrical analysis

- Leases include any document with lease in the title
- Plus . . . a substance over form analysis of what contracts contain a lease

Possible approach

Right to use property for a stated period of time

- True leases
- Certain embedded leases

Scope is a "two sided" / symmetrical analysis

- Considers only right of use transactions
- Purchases recognized similar to finance/capital leases
- Approach would eliminate structures that have been criticized, e.g., synthetic leases
- Plus . . . a substance over form analysis of what contracts contain a lease

The Boards should consider these general leasing concepts as they develop new lease accounting guidance.

IV. TRUE LEASE *versus* FINANCING TRANSACTION

Based on the Discussion Paper, the Boards are not recognizing the fundamental differences between a ***true lease*** and a ***financing transaction***. A ***true lease*** is not a ***financing transaction***, contractually or economically, yet the Boards continue to position the proposed Standard as if it were.

The Boards seek on-balance sheet treatment: for each lease contract, where a lessee would record a right-of-use asset and an obligation to pay rentals. However, all lease contracts are not the same. If the Boards view all lease contracts to be the same, they should clearly set out the basis for conclusion, including consideration of contractual, legal, economic, tax and reporting issues.

In this submission, the term ***true lease*** means 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. In a financing transaction, the lessee's entitlement is that of an in-substance owner; in contrast, under a true lease, the lessee's entitlement is that of a recipient of a service (the right to use an asset).

The table in the Appendix to this paper provides more details on the key characteristics of, and differences between, a true lease and a financing transaction effected through a lease.

The Boards should therefore modify the proposed Standard to reflect these fundamental differences, with these consequences:

- the proposed right-to-use model should be limited to true leases;
- 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;
- if the right-to-use model will apply to all leases, it 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 entire lease contract; and
- a lessee should account for a financing transaction in accordance with current accounting guidance for a finance / capital lease.

The Boards addressed the differences between finance / capital lease and operating leases in their deliberations prior to the issuance of FAS 13 and IAS 17. Those differences remain today, and are reflected in this paper by the distinction between a ***true lease*** and a ***financing transaction***. Since the two transactions are economically and legally different, there must be a strong presumption, coupled with and a user expectation, that the costs of the transactions would not be reported in the same manner.

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. The Boards are concerned that providing guidance to distinguish ***true leases*** from ***financing transactions*** may lead users of the new Standard to follow bright-line tests. However, there is less incentive for financial engineering as in either case the liability would appear on the lessee's balance sheet. The Boards can provide general guidance that is principles-based, focused on the nature of the transaction, the central question being whether substantially all the risks and rewards are transferred. The concept of a transfer of substantially all risks and rewards exists in current accounting guidance and is understood by both preparers and users.

The current accounting guidance for finance or capital leases does not require significant revision. It 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.

In summary, the proposed right-to-use model does not adequately recognize the fundamental differences between a ***true lease*** (that essentially conveys a right to use an asset for a limited period of time) and a ***financing transaction*** (that is used to achieve an in-substance acquisition of an asset by the lessee). Different accounting approaches should be used for these two types of transactions in a manner that would (a) recognize these fundamental differences, and, in particular (b) align expense recognition for the lessee with revenue recognition of the lessor. The lease expense and the measurement for a right-of-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, the economics of a true lease will be more accurately captured and reported.

V. LESSOR ACCOUNTING

Lessor accounting should be excluded from the scope of the Project. The principal objective of the Project is to address off-balance sheet financing issues for lessees. That is achieved in the lessee portion of the Standard. Lessor accounting does not present similar issues, and, more broadly, is well recognized and viewed as satisfactory by the users of financial statements. In short, current rules for lessor accounting are appropriate and do not require change. Assuming the Boards nevertheless include lessor accounting, this paper continues with a more detailed discussion of lessor accounting.

The proposed right-of-use model addresses the objective of requiring a lessee to report operating leases on the balance sheet. With the proposed right-of-use model, the Boards have met the IASB chairman's challenge: "he would like to fly on an aircraft that is on an airline's balance sheet."[1] The right-of-use model provides a solution that is oriented towards lessees, as it creates a separate asset on the lessees' balance sheet along with the linked liability.

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[1] February 2007 meeting in London, England of International Working Group on leasing project.

The Boards are assessing whether to revise lessor accounting. Caution and precision are required. There are a few simple modifications to lessor accounting that would provide symmetry with the right-of-use model, if that is the underlying objective, such as: (i) the bright line nature of the tests prescribed in FAS 13 could be removed in an effort to harmonize lease accounting guidance; and (ii) lessor accounting guidance could be revised for estimates of lease term and lease payments and to provide symmetry with lessee accounting.

The Boards discussed lessor accounting in May and June 2009 and plan to do so again in July 2009. If the Boards decide to include lessor accounting in the scope of this Project, a new Discussion Paper may not be circulated for comment. Should that be the case, a transparent and fair process must be followed leading to the issuance of the Exposure Draft. That would include comprehensive agenda papers addressing lessor accounting, available for public review and comment prior to future Board meetings and the issuance of the Boards' Exposure Draft. These papers must include detailed analysis of, and recommendations for, recognition, measurement and reporting issues for lessors (including manufacturer/dealers).

We have reviewed Approaches A and B proposed in the Discussion Paper and considered the discussions of lessor accounting at the May and June 2009 FASB and IASB Board meetings.

For Approach A, please note the following comments:

1. Approach A is similar to current accounting guidance for finance / sales type leases and focuses on a "sale" of a portion of the leased asset.

2. For lessors who own aircraft / engines subject to operating leases, Approach A represents a change in lessor accounting that would substantially revise their economics and business models. A lessor's statement of operating results would no longer include rental revenue and depreciation; it would only include interest income. Users of a lessor's financial statements understand the differences between operating and finance leases. The fundamental types of assets the lessors would be leasing would be replaced. The cost of debt for a lessor may be affected by implementing Approach A, as the earnings trend of a lessor would be significantly affected as lease revenue would change from a straight-line recognition of rental income to a one-time gain / loss on partial disposal of the leased asset and interest income. Operating lease revenue and depreciation would be replaced with interest income. Implementing Approach A would not provide decision-useful information. Lessors would be viewed as financers of leased assets, which does not represent the economic reality for aviation lessors. That reality is based on the fact that aviation equipment will be leased several times, often with different lessees, over the long useful life of aviation equipment.

3. Approach A involves derecognition of a part of an aircraft / engine (implying that an asset sale occurred and a gain / loss may be recognized) when a lease receivable is recognized. This approach focuses on the transfer of a right-of-use and disregards the fact that a transfer of ownership, either legally or economically, has not occurred. A lessor would be required to proportionally

derecognize an asset based on its future expected use by a lessee - without having transferred title to, ownership of, or the main economic interest in, the subject asset. (Current accounting guidance does not permit derecognition of an asset subject to an operating lease unless the entire asset (including the operating lease) has been sold.) Simply put, the Boards suggestion that such derecognition is appropriate has not been justified by reference to legal or economic criteria. Such justification is required, and should be open to public debate.

4. Approach A may be appropriate for lessors if aircraft / engines are recorded at their "fair" values at the beginning and end of a lease, as only interest income would be recorded as revenue. If aircraft values are recorded at amortized cost at the beginning of a lease and the residual interest is recorded at fair value, then the lease income recognized by a lessor will not reflect an implicit rate based on a fair value assessment of a lease contract.

For Approach B, please note the following comments:

1. Approach B is similar to current accounting guidance for operating leases with the exception of the recognition of a lease receivable and a performance obligation. This approach creates two assets on the balance sheet for every physical asset subject to a lease.

2. For lessors leasing aircraft / engines subject to finance leases, Approach B represents a change in lessor accounting that would substantially revise their economics and business models. A lessor's statement of operating results would no longer include finance lease income; it would include rental revenue and depreciation and may include interest income / expense associated with the lease receivable / performance obligation. Users of a lessor's financial statements understand the differences between operating and finance leases. The cost of debt for a lessor may be affected by implementing Approach B, as the earnings of a lessor will be significantly affected. Implementing Approach B would not provide decision-useful information. Lessors would be viewed as operating lessors when their portfolio includes finance leases, which does not represent the economic reality for lessors who lease assets with finance lease contracts.

3. Manufacturers may be precluded from recognizing revenue / profit at delivery of a new aircraft / engine. Please refer to Part VI for further comments on manufacturers.

4. The Boards are concerned that Approach B creates a doubling up of assets on the lessors' balance sheet. However, the right to receive rental payments and the performance obligation are created as a result of the contract. In the revenue recognition project, a performance obligation is recognized when an entity is contractually required to transfer an asset or service. In a true lease, there is no contractual obligation for a lessor to transfer a physical asset to a lessee. Rather, if a performance obligation should be recognized by a lessor, that obligation relates to a transfer of a service to a lessee, the right to use an asset. The physical asset subject to lease is used to satisfy the performance

obligation of the lessor during the lease term, but ownership and unfettered control is not transferred. Depreciation of the asset represents a portion of the cost of the asset needed to fulfill the performance obligation of the lessor under the lease. If such approach is prescribed, then reporting the lease receivable net of the performance obligation - with disclosure of the components - should be required. Such disclosure would be consistent with the Boards' revenue recognition project (but not with the Boards' proposed reporting by lessees).

5. In order to retain special measurement for lease receivables, as discussed in this paper, lease receivables and obligations to pay rentals should be excluded from the scope of IAS 39 and FAS 114.

A lessor should not recognize income / loss at the inception of a lease in a true lease transaction - since a sale of the leased asset has not occurred. It follows that a lessor should recognize income / loss at the inception of a financing transaction, as a sale of the leased asset has occurred.

An implicit rate in a lease is not equivalent to the interest rate in a financing transaction. An implicit rate in a lease will be significantly affected by elements typical of leases not related to a pure financing transaction. These include the residual value of the leased asset. Yet under both Approaches A and B, a lessor would report interest income as if it were financing the asset, which is not the case in a true lease. Since a lessee and a lessor may use different rates to discount expected lease payments, there will not always be symmetry.

If lessor accounting is included in the Project, the following modified approach is recommended:

1. A lessor should recognize a lease receivable initially measured using the expected cash flows under a most-likely estimate (discounted at a lessor's implicit rate), if a lessee is also required to follow a most-likely estimate. The aircraft would remain on the balance sheet of the lessor.

2. The implicit rate should be derived using the expected cash flows and the fair value of the leased asset at the beginning and end of the lease term. That implicit rate should be used for recognition of lease income by a lessor.

3. A lessor should have the option of recording the physical aircraft asset prior to, during, and at the end of a lease, at either fair value or at amortized cost.

4. A lessor should (a) recognize a performance obligation for the expected cash flows, and (b) report a net lease contract asset / liability with disclosure of the components.

5. The net contract asset / liability would equal the lease receivable net of the performance obligation. A lessor should measure its net contract asset / liability on an amortized cost basis.

6. A lessor would (a) satisfy its performance obligation evenly during the term of a lease contract, and (b) recognize revenue on a straight line basis.

VI. MANUFACTURER ACCOUNTING

The Discussion Paper and the May and June 2009 Board meetings on lessor accounting did not provide clear guidance on the recognition of revenue / profit by a manufacturer when a new aircraft / engine is delivered and subsequently leased by a customer directly or through a lessor.

***A manufacturer should be permitted to recognize revenue / profit when a new aircraft / engine is delivered and a leasing transaction is arranged*.**

The Boards should address this issue as soon as possible.

In the aviation industry, a manufacturer may deliver a new aircraft / engine to a customer, who enters into a leasing contract with a lessor as part of a sale and leaseback transaction. A manufacturer may also deliver a new aircraft / engine to a lessor, which, in turn, enters into a leasing contract with the customer. The leasing contract may be a finance lease or an operating lease.

Current accounting guidance permits a manufacturer to recognize revenue / profit on the delivery of a new aircraft / engine when the leasing contract qualifies as a finance / sales type lease. Current accounting guidance requires a manufacturer to defer recognition of revenue / profit when the leasing contract qualifies as an operating lease. It is critical to retain a manufacturer's ability to recognize revenue / profit on the delivery of a new aircraft / engine when a lease contract is arranged with a customer.

Current accounting guidance provides a framework for sensible solutions to such issues. EITF 00-21 addresses revenue arrangements with multiple deliverables. When a manufacturer delivers a new aircraft / engine to a customer and separately that customer enters into a leasing contract, multiple deliverables exist: (i) a new aircraft / engine and (ii) a leasing contract. The new aircraft / engine has a determinable fair value based on (a) the negotiated sales price, and (b) sale prices for comparable aircraft / engines. A leasing contract has a fair value based on the expected cash flows during the lease term, discounted at the lessor's implicit rate. In order to derive the implicit rate, the fair value of an aircraft / engine is used at the inception and end of a lease. Those fair values are determinable.

The revenue recognition project provides a basis for a manufacturer to recognize revenue / profit on delivery of a new aircraft / engine. A performance obligation would be recognized by the manufacturer. That would be measured at the consideration to be received. It would be satisfied upon delivery of a new aircraft / engine. The lessor would record the aircraft purchase at the sales price. Subsequently, the lessor would record a lease receivable and a residual interest in the aircraft at its expected fair value. This approach would be consistent with current accounting guidance where a lessor provides a finance / sales type lease to a customer.

VII. FAIR VALUE MEASUREMENT

The Boards are assessing fair value measurement in the Project - while recognizing that a trading market does not exist for lease contracts. In that regard, we note the following:

(a) It is possible to measure a lease contract at fair value at inception using an entry price. Yet separate components of a lease contract do not have separate fair values. Separate values may be estimated, but must aggregate to the fair value of the lease contract.

(b) It is not feasible to subsequently measure fair value using an exit price for an obligation to pay rentals without assuming lessor consent to a transfer or lease termination penalties, since both are contractually required.

(c) It is not feasible to subsequently measure fair value of a right-of-use asset without also measuring the fair value of a lease obligation, since the two are inextricably linked.

For items (b) and (c) above, if the Boards require or allow fair value measurement, the aggregate fair value measurement must equal the fair value of the lease contract.

The "exit" price concept in a fair value measurement should be applied in the aviation leasing industry by substituting "entry" for "exit". A lessor/lessee is able to estimate the fair value of a lease transaction based on entering into a lease with a new lessee for a lease term. Using an "entry" price concept, a lessor/lessee would be able to estimate the fair value of a lease transaction based on a new lease with a new lessee for the remainder of the existing lease. Application of the "exit" price concept in the aviation leasing industry is inappropriate since a lessor must consent to a transfer and may impose lease termination penalties.

VIII. FASB AND IASB DIFFERENCES

The Boards should reach consensus positions (on those issues on which they currently differ) before the issuance of the Exposure Draft document.

The Boards have not resolved whether to use a "*most likely*" or a "*probability-weighted*" approach for certain aspects of the Standard. We support a "most likely" approach, as it allows judgment to be exercised to determine a likely outcome based on contractual and non-contractual factors. Reasons also include these drawbacks in the "probability-weighted" approach:

(1) its results may differ from those under the terms of a lease contract; and

(2) complex and sophisticated modeling tools would be needed to implement such an approach.

IX. OTHER CONSIDERATIONS

Right-of-use equivalent to a purchase

The overall effect of the right-of-use model is a purchase of an asset by a lessee using a lease obligation to finance the purchase. If the Boards intend for a lessee to account for a lease contract as an asset purchase, then the proposed guidance should classify the right-of-use asset as a capitalized leasehold asset under current accounting guidance.

Definition of a lease contract

Significant changes are proposed in the Project compared with current lease accounting guidance. The Boards should define what falls within the scope of the Project. This should include whether service contracts are in scope. By providing such guidance, the Boards will improve the ability of entities to identify contracts that fall within the scope of the new guidance and properly implement such guidance.

Performance obligation – providing a service

In a true lease, a lessor is not transferring ownership to a lessee. In the revenue recognition project, a performance obligation involves the transfer of assets or services. A true lease involves a transfer of a service to a lessee. A lessor stands ready to provide the leasing service to a lessee. A lessee will have control of a leased asset during the term of a lease *only if and so long as* it performs its obligations in a lease contract. Since ownership of the leased asset is not transferred in a true lease, a performance obligation in a leasing transaction should be viewed as an obligation for a lessor to transfer a service.

Unit of account

The unit of account for a lease must be the whole lease contract. For a lessor, there should be no delinking of (a) the rights and obligations in a lease contract, and (b) the separate recognition of a right-of-use asset and a lease obligation. If the unit of account is the lease contract, which has created enforceable obligations for both the lessor and the lessee, a lessor should report the lease assets and obligations on a ***net basis*** (as the leasing contract can only give rise in total to either a net asset or a net liability).

The Boards have not provided justification for the delinking of a lease assets and liabilities and for separating subsequent measurement for the linking in a lease contract. In all events, if lease assets and liabilities are to be reported separately, the lease assets and liabilities should remain inextricably linked for measurement purposes.

Tax implications

The changes to lease accounting in the Project affect tax results for countries where tax accounting follows financial accounting without significant book / tax differences. Accordingly, the tax benefits from leasing transactions may change and the

economics of leasing transactions may be affected. This unintended consequence need to be addressed by the Boards.

Distinction between leases and service contracts

The arguments for distinguishing between leases and service contracts should be explored further. Airlines are good examples of entities which frequently enter into composite commercial arrangements involving both service contracts and leases. One example might be the commencement of flights to a new airport where terminal space is provided under lease contract and a range of other services (eg cleaning, passenger and ground handling and access to the runway itself) are provided under service contracts. Thus, as a result of a single event encompassing all these contractual arrangements, the airline has broadened its ability to generate economic benefits for the future. From a theoretical perspective, it is difficult to see why the physical aspect of, say, part of the terminal building (resulting from perhaps a short lease) should be singled out to be put on balance sheet whereas the broader substance of what is entailed is being ignored. Of course, from a practical perspective we would be concerned to see “assets” being added to balance sheets in this way but we provide the example merely to illustrate the apparent illogicality under the new approach of placing such importance on asset delivery as the working group has done.

Consider also a typical ‘wet lease’ arrangement. This is generally a short term arrangement whereby an aircraft and crew is provided to the lessee. Under the new approach, we would be directed to consider this as a lease (the provision of the aircraft) with a service contract component (the provision of flight crew) and account separately for each component, one part on balance sheet and the other off balance sheet. In our view, the contract cannot sensibly be segmented in this way; without the crew, the aircraft is of no value as it cannot be flown.

Likewise, in our view, the rights obtained from a lease of a property for, say, two years are not really so different to the rights obtained from, for example, a contract to clean that property. Both give a right to service over a two year period; provision of accommodation on the one hand and provision of cleaning services on the other. Yet under the new approach, the lease contact would be capitalised and put on balance sheet but the cleaning contract not.

In summary, we appreciate the Boards’ desire to exclude service contracts from the scope of this project as significant additional complexity would result. But we question though whether the distinction is entirely consistent with the theoretical framework it is founded on. Excluding assets and liabilities by not capitalizing service contracts seems to us no better in principle than excluding them by not capitalizing operating leases.

X. RESPONSES TO QUESTIONS IN DISCUSSION PAPER

For each question in the Discussion Paper, we present our response, comments, and rationale, and, where appropriate, alternatives for the Boards to consider.

1. CHAPTER 2: SCOPE OF LEASE ACCOUNTING STANDARD

Q1 *The Boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.*

Please refer to our earlier comments in Parts II to IX.

If the scope of the new lease accounting standard is not consistent (between FASB and IASB rules), we believe that harmonized international accounting will not occur. It appears that the Boards' approach to scope may be driven by timing and project management considerations. If that is the case, we recommend that the Boards add leasing scope harmonization to their project agenda.

The Boards should clarify whether lease transactions represent a transfer of a good or a transfer of a service for purposes of assessing revenue recognition. A true lease does not involve a transfer of a good. With a true lease, a lessor provides a service to a lessee by renting the leased asset, and, as a result, the lease revenue and lease cost should be recognized ratably over the term of the lease. For example, assume a company (i) leases a computer system along with the required support employees or (ii) signs a service contract for the same computer system and support. A lease will lead to recognizing right-of-use assets and obligations, while a service contract would not recognize these assets and liabilities.

Q2 *Should the proposed new standard exclude non-core assets or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.*

The Standard should not exclude non-core assets or short-term leases, because: (i) non-core assets, whether owned or leased, are a component of an entity's financial condition that should be reported; and (ii) exclusion of short-term leases would encourage "engineering" of leasing transactions.

The Boards should consider the practical implications of including non-core or short term leases in the scope of this Project. Implementing the proposed accounting guidance may require entities to significantly change existing information systems and processes and / or implement new information systems and processes. The Boards should consider these practical implications when deciding on implementation dates for the new lease accounting guidance.

2. CHAPTER 3: APPROACH TO LESSEE ACCOUNTING

Q3 *Do you agree with the Boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.*

We agree with the Boards' analysis, subject to our comments in Parts II to IX and our responses to the Boards' questions presented in this position paper.

Q4 *The Boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognize: (a) an asset representing the right to use the leased asset for the lease term (the right-of-use asset) and (b) a liability for its obligations to pay rentals. Do you support the proposed approach? If you support an alternative approach, please describe the approach and why you support it.*

No, we support the approach existing in current standards (approach described in paragraph C9 of appendix C in the Discussion Paper).

Please refer to our comments in Parts II to IX.

Q5 *The Boards tentatively decided not to adopt a components approach to lease contracts. Instead, the Boards tentatively decided to adopt an approach whereby the lessee recognizes: (a) a single right-of-use asset that includes rights acquired under options and (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees. Do you support this proposed approach? If not, why?*

We agree with this approach; however, we believe that this approach represents a bifurcation of a lease contract - the appropriate unit of account - into component parts. No justification has been given as to why (a) a lease contract should not be not the unit of account and (b) the component rights and obligations should be delinked.

3. CHAPTER 4: INITIAL ASSESSMENT

Q6 *Do you agree with the Boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?*

No. We recommend the use of the interest rate implicit in the lease. This is due to the fact that the implicit rate in the lease reflects the specific liability being measured and better aligns with the measurement of liabilities in IFRS standards such as IAS 39.

In a commercial context, lessees will undertake a lease versus buy analysis prior to committing to a lease. In undertaking this analysis, the lessee will research what they believe the fair value of the asset they are leasing is and an estimated residual value at the end of the lease term. For large assets such as aircraft, there is considerable information available to make appropriate estimates and lessors will often be asked to provide sufficient information for airlines to complete the 'rate implicit in the lease' calculation.

If the rate implicit in the lease cannot be determined, then the lessee should have the option to utilize an incremental borrowing rate assumption.

Q7 *Do you agree with the Boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.*

We agree with this decision.

4. CHAPTER 5: SUBSEQUENT MEASUREMENT

Q8 *The Boards tentatively decided to adopt an amortized cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with the proposed approach? If you disagree with the Boards' proposed approach, please describe the approach to subsequent measurement and why.*

No, we do not agree. Delinking the right-of-use asset from the lease obligation means the unit of account is not the lease contract. Delinking represents a component approach to lease accounting, which is inconsistent with the Boards' intention to not use a component approach for the right-of-use model.

In Part V, we present key differences between a ***true lease*** and a ***financing transaction***. We continue to believe that the Boards are disregarding these critical differences.

The rights and obligations in a lease are inextricably linked. The whole lease contract should be the unit of account, a position that is consistent with the Boards' revenue recognition proposal. If the right-of-use asset and lease obligation are reported separately, contractual linkage should be retained. Generally, when a lessee terminates a lease contract, a lessee may reduce its termination obligation to a lessor by return of the leased asset. This right of offset for a lessee provides evidence of continued linkage between a lease obligation and the right to use the leased asset.

If the right-of-use asset and lease obligation are delinked for recognition, measurement and reporting, a clear justification must be provided for bifurcating these components of a contract.

In a true lease, the lessee does not purchase the right-of-use asset. Since a purchase has not occurred, a right-of-use asset should not be measured with the amortized-cost approach.

The Boards presented only one example of a linked approach and presented three reasons for discarding their linked approach example. The reasons cited by the Boards do not give full consideration to the fundamental differences between a true lease and a financing transaction. We have the following comments on the Boards' reasons:

(a) The linked approach does differentiate between financing transactions using a lease and true leases because they are different. By concluding

that a linked approach is not appropriate, the Boards are disregarding these fundamental differences.

(b) The right-of-use asset in a true lease should not be subject to the same subsequent measurement as a right-of-use asset in a financing transaction since a lessee does not purchase a right-of-use asset.

(c) The links between a right-of-use asset and a lease obligation remain after lease inception and are enforceable throughout a lease contract.

(d) Subsequent changes in the carrying value of a right-of-use asset due to impairments or increases in the value (under international accounting standards only) may be recorded and monitored separately while still retaining the merits of a linked approach.

(e) An obligation to pay rentals is similar to a financial obligation. However, unlike financial obligations, a link exists between satisfaction of a lease obligation and a lessee's benefit from a right-of-use asset.

A linked approach should result in a lessee recording rental expense equal to its rental payments. Subsequent measurement of a right-of-use asset will need to be linked in some way to the subsequent measurement of an obligation to pay rentals. Any linked approach will have its strengths and weaknesses.

In Exhibit A to this position paper we present another linked approach example for consideration.

Q9 *Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.*

A lessee should be able to elect to measure its obligation to pay rentals at fair value. We identify the following issues relating to a fair value measurement for lease contracts:

(1) A lease contract is the appropriate unit of account and may be measured at fair value. Fair value, in turn, may be allocated to lease assets and liabilities.

(2) Allocation of fair value for a lease contract should be linked. The fair value of a lease contract may be allocated to a right-of-use asset and a lease obligation if their aggregrate fair value equals the fair value of a lease contract. A right-of-use asset and lease obligation are inextricably linked, and that linkage should be retained during measurement.

(3) A lessee does not generally have the ability to transfer its lease obligation without consent of the lessor. A lessee does not generally have the ability to terminate its lease obligation without incurring a significant penalty. A fair value measurement of a lease obligation assuming the most advantageous market may not recognize contractual penalties or required lessor consent.

(4) A lessee would generally not be able to use an exit price to estimate its fair value. An entry price is more appropriate as it would reflect receipt of lessor consent. An entry price is not currently available as a basis for fair value measurement under U.S. and proposed international accounting standards.

(5) International and U.S. accounting guidance for impairment should be harmonized for consistent reporting.

Q10 *Should the lessee be required to revise its obligations to pay rentals to reflect changes in its incremental borrowing rate? Please explain your answer. If the Boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your answer.*

A lessee should revise its obligations to pay rentals to reflect changes in its incremental borrowing rate only if a lessee elects fair value measurement for its obligation.

If a lessee is to re-measure its lease obligation, this re-measurement should occur each reporting period.

Q11 *In developing their preliminary views the Boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the Boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the Boards? If you disagree, please explain why.*

If the Boards decide (i) not to follow a linked approach to subsequent measurement for a lessee's right-of-use asset and obligation to pay rentals and (ii) not to allow a lessee to elect fair value, then we support accounting for the obligation to pay rentals as the Boards have specified. The Boards should address how the lease accounting guidance compares with the financial instrument measurement project on the Boards' agenda.

Q12 *Some Board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortization or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.*

We agree with this approach. For ***true leases***, a lessee should recognize expense during the term of a lease equal to its rental payments on a straight line basis. We present one example of a linked approach in Exhibit A. An appropriate linked approach that recognizes the lease contract as the unit of account will recognize the fundamental differences between a true lease and a financing transaction. Changing lessee recognition of rental expense will affect key financial measurements such as EBITDA.

5. CHAPTER 6: LEASES WITH OPTIONS

Q13 *The Boards tentatively decided that the lessee should recognize an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The Boards tentatively decided that the lease term should be the most likely lease term. Do you support this proposed approach? If you disagree with this proposed approach, please describe what alternative approach you would support and why.*

While there is some merit to this approach, we do not believe that an obligation to pay rentals during an option period exists until a lessee has exercised the option. The Boards need to address whether an option period meets the working definition of a liability and how inclusion of an option period is consistent with the financial instrument model. Until an option is exercised, a lessee does not have a contractual obligation for lease payments during the option period.

Q14 *The Boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognized as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why. Would requiring reassessment of the lease term provide users of financial statements with some relevant information? Please explain why.*

We agree with this approach. However, we believe the Boards should consider if this approach is practical. Requiring lessees and lessors to reassess lease terms each reporting period will involve significant resource commitments without commensurate benefits.

Q15 *The Boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.*

We agree with this approach.

6. CHAPTER 7: CONTINGENT RENTALS AND RESIDUAL VALUE GUARANTEES

Q16 *The Boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you support and why?*

We agree with this approach. We do not believe that fixed and/or contingent rents during an option period represent a liability for a lessee until a lessee exercises the option to extend a lease. The Boards should provide clear guidance describing how lease payments during an unexercised option period meet the Boards' current and working definitions of a liability.

Q17 *The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reason.*

We support the most-likely approach which is consistent with a principles-based accounting standard. Measurement results using the probability-weighted approach may be different from actual results achievable in a lease contract. A probability-weighted approach is a more complex solution than necessary. The most likely approach would also allow for the appropriate considerations of other factors not susceptible to probability-weighted analysis.

Q18 *The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index existing at the inception of the lease. Do you support the proposed approach? Please explain your reasons.*

We agree with this approach. While this disregards the fact that future changes in interest rates and indices are generally estimable, such future estimation would add unnecessary complexity and difficulty to measuring an obligation to pay rentals.

Q19 *The Boards tentatively decided to require re-measurement of a lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.*

We agree with this approach. Clearer guidance is needed on why an option period in a lease meets the Boards' working definition of a liability. Lease payments in an option period become an obligation / receivable only when the option is exercised.

Q20 *The Boards discussed two possible approaches to recognizing all changes in the lessee's obligation to pay rentals arising from changes in estimating contingent rental payments: (a) recognize any change in the liability to profit or loss or (b) recognize any change in the liability as an adjustment to the carrying amount of the right-of-use asset. Which of these two approaches do you support? Please explain your answer. If you support neither approach, please describe any alternative approach you would prefer and why.*

We agree with option (b). Changes in the value of the lease obligation represent future, not current or past, changes in cash outflows that are inextricably linked to the future value of right-of-use assets. Reporting changes in the lessee's obligation to pay rentals as profit or loss would distort reporting for the period of the change.

Q21 *The Boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the Boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why.*

We agree with this approach.

7. CHAPTER 8: PRESENTATION

Q22 *Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reason. What additional information would separate presentation provide?*

Yes, a lessee's obligation should be presented separately, if material. Otherwise, disclosure in the notes to the statement of financial position about a lessee's obligations to pay rentals would be appropriate. The notes to the financial statements should include disclosure of fixed and contingent lease cash flows to provide more decision-useful information about a lessee's obligations and future cash outflows.

Q23 *This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? What additional disclosures (if any) do you think are necessary under each of the approaches?*

The assets relating to financing transactions should be presented based on the nature of the asset. Right-of-use assets relating to true leases should be reported as intangible assets. Disclosures for right-of-use assets should describe the general terms of true leases or financing transactions including the amortization method, period of amortization and options to purchase asset.

Presentation of leasing activities in the cash flow statement needs to be addressed. Since a lease contract represents one unit of account, cash flows from leasing activities should be presented in the same section of a cash flow statement.

8. CHAPTER 9: OTHER LESSEE ISSUES

Q24 *Are there any lessee issues not described in the discussion paper that should be addressed in this project? Please describe those issues.*

Please see Part IV for other lessee issues.

9. CHAPTER 10: LESSOR ACCOUNTING

Q25 *Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.*

Yes. A lessor's right to receive rentals is a contractual right provided in a lease and meets the definition of an asset.

Q26 *This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased items by the lessor or (b) recognition of a performance obligation by the lessor. Which of these two approaches do you support? Please explain your answer.*

Part V includes our comments relating to Approaches A and B for lessor accounting.

Q27 *Should the Boards explore when it would be appropriate for a lessor to recognize income at the inception of a lease? Please explain your answer.*

In Part VI, we address this topic for manufacturers who sell assets that are subsequently leased. A manufacturer that sells an aircraft should recognize revenue on delivery of an aircraft, including when its customer, in turn, leases that aircraft.

A lessor should not recognize income / loss at the inception of a lease in a true lease transaction since a sale of the leased asset has not occurred. A lessor should recognize income / loss at the inception of a financing transaction that uses a lease contract as a sale of the leased asset has occurred.

Q28 *Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your answer.*

The Boards should include investment properties in the scope of the Project to support harmonized international accounting standards and more decision-useful financial reporting.

Q29 *Are there any lessor accounting issues not described in this discussion paper that the Boards should consider? Please describe those issues.*

We have included comments in Parts V and VI.

The Boards should address accounting for lease incentives.

The Boards should provide an adequate transition period - at least two years - for lessors to implement the guidance provided in the Standard.

In order to present comparable financial statements and decision-useful information, the Boards should evaluate how entities should report the adoption of this new Standard.

APPENDIX – MAIN DIFFERENCES BETWEEN A TRUE LEASE AND A FINANCING TRANSACTION

True Lease	Financing Transaction (using a lease)
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.	A lessee uses a lease to accomplish an in-substance purchase of the leased equipment.
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.	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.
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.	The lessor does not expect to have the financed equipment returned by the lessee during or at the end of the lease term.
The lessor remains the legal and economic owner, with a wide range of legal implications.	The lessor views its title to the equipment as security for its in-substance loan.
The lessor expects to realize the tax benefits of ownership, and does not transfer such benefits to the lessee.	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.
The lessor considers the residual value, re-leasing 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.	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.
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.	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.
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.	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.
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.	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.

Exhibit A
Linked Approach

Assumptions

Lease term	5 years	
Annual lease payments in arrears	2,638	CU
Lessee implicit/incremental borrowing rate	10%	

`	Inception	Year 1	Year 2	Year 3	Year 4	Year 5
			Unit of measure - CU			
Financial position						
Right of use asset						
Cost	10,000	10,000	8,362	6,560	4,578	2,398
Accretion		1,000	836	656	458	240
Amortization		(2,638)	(2,638)	(2,638)	(2,638)	(2,638)
Net cost	10,000	8,362	6,560	4,578	2,398	-
Obligation to pay rentals	10,000	8,362	6,560	4,578	2,398	-
Income statement						
Interest revenue		1,000	836	656	458	240
Interest expense		(1,000)	(836)	(656)	(458)	(240)
Lease expense		(2,638)	(2,638)	(2,638)	(2,638)	(2,638)
Net profit (loss)		(2,638)	(2,638)	(2,638)	(2,638)	(2,638)
Cash flow						
Lease payments		2,638	2,638	2,638	2,638	2,638