AVIATION WORKING GROUP

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Aviation Working Group – Comments on Leasing Project

Dear Sir David Tweedie and Mr. Herz:

The Aviation Working Group (***AWG***) is an industry group whose members consist of the leading manufacturers, lessors, and financiers of aircraft and aircraft engines. AWG has been closely following and reviewing with interest the leasing project activities of the FASB and IASB.

The original purpose of the leasing project was to address concerns users of financial statements had with respect to lease contracts for lessees, in particular the perceived abuse of the current lease accounting rules for off balance sheet financing. Such abuse, perceived or otherwise, is not applicable to lessor accounting. The current accounting guidance for lessors is well understood by preparers and users of financial statements, reflects the economics of leasing transactions, and provides decision useful information.

AWG is providing this letter prior to the issuance of the Exposure Draft since there are two issues of great importance to lessors in connection with the proposed new lease accounting standard:

- transfer of control criteria for lease contracts, that is, the recognition of a sales/finance transaction and
- lessors using Approaches A (derecognition) or B (performance obligation) to account for all for lease contracts.

Transfer of control criteria for lease contracts

Current accounting guidance for sales / finance lease classification by lessors is based on the premise that, from an economic perspective, substantially all risks and rewards have transferred from a lessor to a lessee. That economic foundation is a crucial component in business models for those companies entering into and holding sales / finance leases. The recovery by the lessor of its investment (with a reasonable rate of return) from the lease payments demonstrates that a transfer of control has occurred.

The Boards are discussing criteria for lease contracts that would be used to identify lease contracts to be excluded from the scope of the new leasing standard. Such exclusion would result in recognition of a purchase by the lessee and a sale by the lessor of the underlying leased asset. The Boards have identified two criteria which would lead to the scoping out of a lease from the new lease standard:

(i) Automatic transfer of title at the end of a lease contract, or
(ii) The inclusion of a bargain purchase option in a lease contract.

The Boards' staff presented in IASB agenda paper 9D / FASB memo 56, three additional criteria:

1. Contracts that cover the whole of the expected useful life of the underlying asset,
2. Contracts that are expected to cover the whole of the expected useful life of the underlying asset because they include options to renew the lease at a bargain price, or
3. Contracts where the return that the lessor receives is fixed.

The three additional criteria being considered by the Boards ***should be retained for scope exclusion***. However, they should be ***modified to adopt criteria that embrace the economics involved in a transfer of control and the transfer of "substantially all the risks and rewards*."** For example, if the discounted cash flows in a lease represent substantially all the fair value of a leased asset at lease inception, that is objective evidence that a sale and financing have occurred. The key issue is whether by entering into the lease contract the lessor recovers substantially all of its investment in the leased asset from the lessee. We submit that such a situation is sufficient evidence of a deemed transfer of control.

Applying the current accounting guidance reflects the economic substance of the transaction – which is the use of a lease to finance the sale of an asset to a lessee. We understand that the Boards want to eliminate the bright line tests under U.S. GAAP used for classification of leases. However, the Boards should retain the concept that when leases transfer substantially all the significant risks and rewards associated with the leased assets from a lessor to a lessee, control should be deemed to have transferred to the lessee.

The exclusion criteria should be expanded to cover not only lease renewal and purchase options but also other features which demonstrate the lessor's ability to recover substantially all of the value of the asset with a reasonable return. If the Boards chose only the two criteria described above, the Boards are discarding this concept. By doing so, the Boards would not recognize that debt financing and sales/finance lease transactions are substantially the same. Instead, the Boards would be focusing on the form of the transaction. The accounting for transactions that are economically the same should receive similar accounting treatment.

Lessors using Approaches A (derecognition) or B (performance obligation) to account for all lease contracts

The Boards have focused on selecting one approach for lessors and lessees to use when accounting and reporting lease contracts. The leasing industry has developed operating strategies that have proven successful whether a lessor uses operating or sales / finance leases. Limiting the accounting model to one approach will lead to significant changes in the leasing industry. By creating the exclusion criteria, the Boards have effectively developed two approaches in the same manner as current accounting literature. Why not have all lease transactions properly covered in the new pronouncement and use the “exclusion” criteria to determine which approach to follow? Given the Boards struggle to identify appropriate criteria indicating that a lessor has transferred control of an asset to a lessee, the ***Boards should consider changing their position to require lessors to use approach A (derecognition) when a transfer of control exists (meeting the above criteria) and approach B (performance obligation) when a transfer of control has not occurred***.

If a lessor were required to evaluate the proper approach based on the economics of a lease contract, including whether substantially all the risks and rewards relating to a leased asset have been transferred to a lessee, a lessor would be able to exercise proper judgment in applying approach A or B and presenting decision useful information. This would limit possible structuring issues if the new pronouncement covered all lease transactions and eliminate any revenue recognition issues which could result from such silence.

We would be pleased to discuss these comments further with the Boards and their staff.

Respectfully,

Jeffrey Wool
Secretary and General Counsel
Aviation Working Group