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cutting through complexity

GLOBAL AVIATION GROUP

Leases: Final Approach or Go-around?

Another US$100 billion of debt for the top global airlines

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Key impacts

- The IASB and FASB propose a major shake-up of lease accounting in revised proposals published in May 2013. The proposals would have a significant effect throughout the industry, impacting both airlines and aviation financiers.
- The proposals would bring most leases on-balance sheet for lessees. KPMG International estimates that this could add over US$100 billion of debt to the balance sheets of the top 20 global airlines.
- The proposals would accelerate recognition of lease expense for most leases of aircraft currently classified as operating leases.
- A complex new accounting model would apply to aircraft lessors.
- We encourage all interested parties to send their comments on the proposals to the IASB and FASB by the deadline of 13 September 2013.

Introduction

The International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) released a joint revised exposure draft on lease accounting on 16 May 2013 (the ED). There is a 120-day comment period. Both the IASB and the FASB have indicated that they will perform extensive outreach during the comment period.

Under the ED, operating lease agreements would be brought onto the balance sheets of lessees. A lessee would recognise a new lease liability and a corresponding 'right-of-use' asset that would be depreciated over the term of the lease. KPMG estimate that this could add over US$100 billion in debt to the balance sheets of the top 20 global airlines.

Operating leases of aircraft, engines and airport facilities are used extensively throughout the global airline industry. Capitalising these leases would significantly change the balance sheets of many airlines. The proposed guidance would also significantly change the income statement profile for many leases, accelerating expense recognition compared to current operating lease treatment.

The ED aims to respond to long standing criticism that lease accounting has been too permissive of off-balance sheet treatment by lessees. However many may feel that the ED is overly complex and dominated by arbitrary rules.

KPMG has identified a number of issues with a likely significant impact on airlines (lessees) and aviation financiers (lessors), which are described below.

We encourage airlines and aviation financiers who wish to see these issues resolved prior to the issuance of a final standard to submit comment letters to the IASB and FASB before the comment deadline of 13 September 2013.

Issues for aviation

1. Foreign currency remeasurement of new lease account balances

This is an international airline issue and not relevant to airlines or aviation financiers who use USD as their functional currency

Proposal

A lessee would recognise a right-of-use asset on its balance sheet as a non-financial asset, measured initially at the present value of the estimated future lease payments. As a non-monetary asset this balance would not be remeasured to reflect exchange rate movements.

A lessee would recognise a lease liability on its balance sheet as a financial liability. Under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as a monetary item it would be remeasured each period to reflect exchange rate movements.

A lessor would recognise a lease receivable and a residual asset on its balance sheet. The lease receivable would be a financial asset. As a monetary asset this would be remeasured each period to reflect exchange rate movements. The residual asset would be a non-financial asset and, though the ED is not explicit on this point, would likely be a non-monetary asset and so would not be remeasured to reflect exchange rate movements.

Aviation industry implications

Lessee (airline industry) implications		Lessor (aviation financier) implications	
Many airlines with a functional currency other than USD are a party to USD denominated leases. Under the proposals, adjusting the liability but not the asset for changes in exchange rates has the potential to create significant income statement volatility. If the final standard does not address this issue, then airlines in this position that hold USD denominated debt may consider designating the foreign currency risk on the liability in a hedge. This accounting would require careful consideration and liaison with accounting advisors and auditors.		The functional currency for most dedicated aviation financiers and lessors is the USD. Under the proposals, part of a non-monetary asset (the leased aircraft) would become a monetary asset (the lease receivable). However, if the lease is denominated in the functional currency of the lessor, there will be no retranslation and no significant additional volatility in the income statements of lessors. However, for non-USD functional currency lessors that enter into USD denominated leases, this issue would create additional volatility in the income statement and would require consideration of a need to enter into hedging arrangements and/or apply hedge accounting to reduce the earnings volatility. Lessors may also face increasing requests from airline lessees to denominate aircraft leases in currencies other than USD.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	Low	High

2. Introduction of a new lease classification test

Proposal

IAS 17 *Leases* distinguishes between operating and finance leases. Leases under which 'significantly all' the risks and rewards of ownership of an asset are transferred to the lessee are defined as finance leases and are capitalised by lessees on the balance sheet. Leases other than finance leases are defined as operating leases. They are not capitalised by lessees and the related expense is generally recognised on a straight-line basis over the term of the lease.

FASB ASC Topic 840 *Leases* also distinguishes between an operating and a capital lease based on similar guidance; however, it also contains 'bright line' quantitative tests based on the present value of the future minimum lease payments and the economic life of the underlying asset.

The proposals introduce new dual lease accounting models – and a new lease classification test to assess whether a lease is Type A lease or Type B lease.

Type A and Type B leases would both be on balance sheet for the lessee – but with a different profile of lease expense. A lessor would apply a complex new accounting model to Type A leases but would continue to apply a version of current operating lease accounting to Type B leases.

Underlying asset*	Lease classification
Non-property	Type A, unless: • the lease term is for an insignificant part of the total economic life of the underlying asset; or • the present value of the lease payments is insignificant relative to the fair value of the underlying asset.
Property	Type B, unless: • the lease term is for the major part of the remaining economic life of the underlying asset; or • the present value of the lease payments accounts for substantially all of the fair value of the underlying asset.

*Land and/or a building

The new threshold of 'insignificant' is critical in determining the classification and hence the accounting model to be applied to a lease arrangement, and could be an area of significant judgement in accounting for leases. This is particularly so in the case of 'big ticket' assets, such as aircraft and related assets, that cost a substantial amount and have long useful economic lives. For example, judgement would be required to determine what is insignificant in the context of the leasing of an aircraft that costs US$150m and is expected to operate for 25 years or more.

The risk of differing interpretations as to what constitutes insignificant will likely increase for second-hand (other-than-new) aircraft when varying views of aircraft values and remaining lives could result in different accounting treatments being applied to similar transactions.

Aviation industry implications

<table>
<tr><th colspan="2">Lessee (airline industry) implications</th><th colspan="2">Lessor (aviation financier) implications</th></tr>
<tr><td colspan="4">The ED does not define what is significant or insignificant and, therefore, will require the application of judgment. Most existing aircraft operating leases will likely be for more than an insignificant part of the economic life of the aircraft and similarly the lease rental payments will be more than insignificant, relative to the fair value of the aircraft – except for the very shortest aircraft leases.</td></tr>
<tr><td colspan="2">Many existing aircraft operating leases are expected to be classified as Type A under the proposals. Therefore, they would be recognised on the balance sheet and the lease expense in the income statement would be front loaded.

This will lead to a greater income statement charge for interest in the first half of the lease when compared to the second half. This will impact airlines differently depending on the current portfolio of operating leased aircraft and the strategy for managing lease renewals. For example, it is likely to accelerate recognition of total lease expense for an airline that is expanding and entering into many new leases.</td><td colspan="2">Most existing operating leases are expected to be classified as Type A under the proposals. Therefore, the lessor would derecognise the aircraft asset and recognise a lease receivable for the right to receive payments and a residual asset. This will often result in day one profit on lease commencement and in the frontloading of lease income over the term of the lease.

This may have implications for lessors seeking to raise funds in the capital markets. Without regular renewal or growth in a fleet, the income profile will always be declining, notwithstanding that the cash flows may be constant.</td></tr>
<tr><th>Likelihood of Impact</th><th>Potential Impact</th><th>Likelihood of Impact</th><th>Potential Impact</th></tr>
<tr><td>High</td><td>High</td><td>High</td><td>High</td></tr>
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3. Component accounting for the right-of-use asset

This is a specific requirement under IFRS and not a requirement of US GAAP, therefore this is not relevant for airlines that report their financial statements in accordance with US GAAP

Proposal

The right-of-use asset that the airline would recognise in an aircraft would be an intangible asset, though it would be presented as part of property, plant and equipment. It is unclear how the proposals interact with the requirements of IAS 16 *Property, Plant and Equipment* for component accounting and whether significant components of the right-of-use asset would have to be accounted for separately.

Aviation industry implications

Lessee (airline industry) implications	Lessor (aviation financier) implications
Under IAS 16, airlines are required to identify significant components of aircraft and separately assess the useful economic life and residual value. This ensures that the charge to the income statement is consistent with the use of the asset. Airlines would welcome the ability to account for the right-of-use asset in the same way.	
Likelihood of Impact	**Potential Impact**
Moderate	Moderate

4. Accounting for maintenance rentals/supplemental rents ("maintenance payments")

Proposal

In many aircraft operating lease arrangements the airline lessee is obliged to maintain the aircraft at its own cost and to make payments to the lessor based on usage (flight hours and cycles of the aircraft and its major components – airframe, engines, etc). The usage-based payments may or may not be related specifically to maintenance services provided by the lessor. If the lessor does not provide the maintenance service itself, then the lessor usually agrees to make a contribution to the cost of aircraft maintenance undertaken by the lessee. The detailed terms and conditions vary between agreements.

The ED does not include specific guidance on this complex topic. Lessees and lessors of aircraft will be concerned as to whether it is sufficiently clear how to apply the general principles of the ED to these arrangements – and how the resulting accounting compares to the current, sometimes diverse, accounting approaches seen in practice.

Aviation industry implications

Lessee (airline industry) implications		Lessor (aviation financier) implications	
The maintenance accounting for aircraft is complex. The interplay of existing maintenance accounting requirements under US GAAP and the multiple models under IFRS will require detailed review. The bottom line is that the profile of maintenance expense over the term of the lease could be significantly different in some cases.		If maintenance charges are considered part of the lease, the lessor is likely to recognise variable lease payments relating to maintenance as income as earned, together with a corresponding expense reflecting the write-off of expected maintenance payments included in the carrying amount of the residual asset component. This treatment could give rise to significantly different reported results than those under current standards – potentially significantly changing both the timing and amount of maintenance income recorded over the term of a lease. Application of the proposals is likely to require development of additional models and systems to account for the residual asset and appropriately test the residual asset for impairment.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High

A key step in the analysis would be to assess the nature of the maintenance payments – whether they are a separate non-lease component of the arrangement, or part of the lease.

If the maintenance payments are a separate non-lease component, then they would be accounted under the general requirements for revenue and maintenance costs.

If the maintenance payments are part of the lease, then they would often be accounted for under the ED's guidance on variable lease payments. This means they would not be included in the initial measurement of the lessee's lease liability or the lessor's lease receivable. Instead, the lessee would account for them as incurred. The lessor would include estimated maintenance payments in the residual asset on lease commencement; over the term of the lease, the lessor would recognise the actual maintenance payments as earned and write-off to profit or loss a portion of the expected payments included in the residual asset.

A further complication will be the treatment of payments by the lessor, including whether these should be seen as a reduction in the lessee payments, a lease incentive or a separate cash flow.

As a result of these issues there could be a significant difference in the profile of income and expense recognition. Also, lessors could face asymmetry regarding accounting for changes in expected return condition: if the aircraft is returned below its scheduled condition the lessor could face an impairment – but there is no mechanism to increase the carrying amount of the residual asset if the aircraft is returned in better than scheduled condition.

5. Sale and leaseback transactions

Proposal

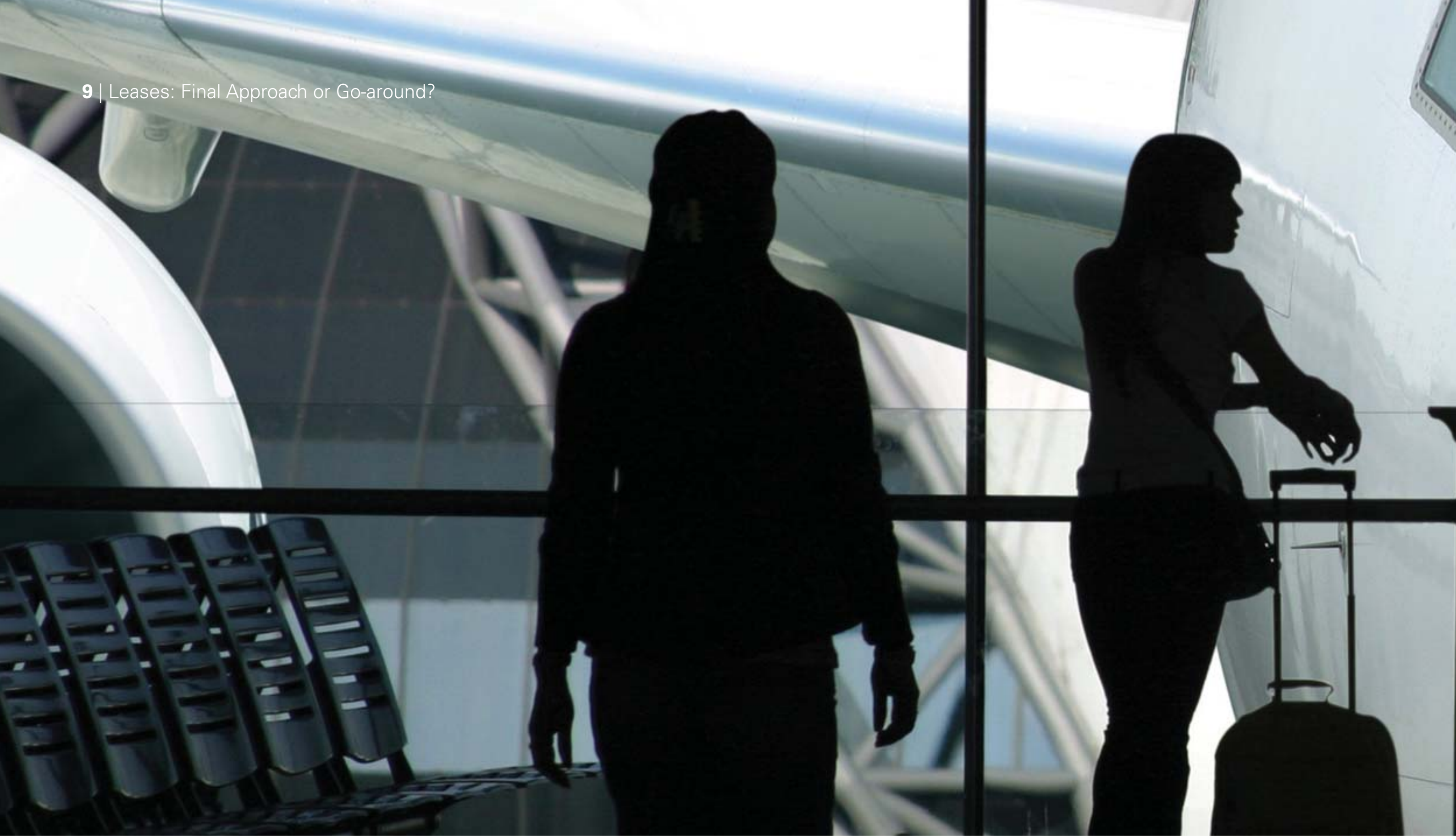
Some aircraft purchases by airlines are immediately followed by a sale and leaseback transaction with an aircraft leasing company. These transactions result in a gain or loss, in either in the profit or loss or deferred on the balance sheet, being recognised by the airline and result in either an operating or finance lease of the aircraft.

Under the ED, a sale and leaseback of the aircraft would be recognised if the requirements for sale recognition in the forthcoming revenue recognition standard are met; otherwise, the transaction would be accounted for as a financing. The existence of the leaseback would not, on its own, result in a conclusion that the buyer-lessor did not obtain control of the underlying asset under the forthcoming revenue recognition standard's provisions. In all cases, a sale-leaseback transaction would be accounted for as a financing rather than a separate sale and leaseback if:

- the lease term is for a major part of the remaining economic life of the underlying asset; or
- the present value of the lease payments amounts to substantially all of the fair value of the underlying asset.

Aviation industry implications

Lessee (airline industry) implications		Lessor (aviation financier) implications	
The ED does not define how to determine a 'major part' or 'substantially all' and therefore each contemplated sale and leaseback transaction will require careful consideration and judgement as to whether it qualifies as such or is to be treated as a financing.			
Airlines that engage in sale and leaseback transactions for commercial, financing or other financial reasons will need to reconsider their accounting due to the change in treatment under proposed guidance.		If a current lease arrangement is assessed as a sale and finance leaseback under current IAS 17 and ASC 840, it is likely to be treated as not a sale but a financing arrangement. The exclusion of the transaction from the Leases standard will mean that receivables arising would not be lease receivables but would be within the measurement scope of IAS 39 *Financial Instruments: Recognition and Measurement* and, when effective, IFRS 9 *Financial Instruments*. If this occurs, then arrangements that are assessed to be financing and not sale and leasebacks and contain options and interest or tax variations may fail the solely for payment of principal and interest ("SPPI") test under IFRS 9 and would consequently be accounted for at fair value through profit or loss. This treatment would differ from the current sale and leaseback accounting treatment under IAS 17.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High



6. Other variable or contingent rentals

Proposal

Variable payments that depend on an index or a rate would initially be measured using the index or rate at the lease commencement date. The lease payments would then be recomputed at each reporting date if there is a significant change in the index or rate. Other contingent rentals would be recognised in the period to which they relate. For the aviation industry, interest and tax variation clauses are common terms found in a lease arrangement and changes to interest and tax rates subsequent to the commencement dates are likely to be assessed as significant.

Aviation industry implications

Lessee (airline industry) implications		Lessor (aviation financier) implications	
Lessees would be required to reassess the future cash flows and to adjust the right-of-use asset. This will introduce balance sheet volatility and make it difficult for lessees to forecast future covenant compliance etc. In some cases the lessee may not have all the necessary information to allocate the change between future and past periods particularly if the lease is a complex tax-based lease and/or if the lessee does not know the lessor's assumed residual value.		The lessor would have sufficient information and may not find it difficult to perform the reassessment and adjustments, when required. The lessor however, may face an operational challenge as it may be inundated with requests for information from lessees with such variable rental arrangements.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	Low	High

7. Identification and separate treatment of service component

Proposal

If a contract includes a service component, then the lessee would account separately for the components unless there are no observable prices that can be used to allocate the payments between service and lease components. Lessors would always account for the components separately, using the revenue guidance to allocate payments.

Aviation industry implications

Lessee (airline industry) implications	Lessor (aviation financier) implications

Some aircraft and related assets leasing contracts involve items such as complicated maintenance / supplemental rent arrangements (where the basis of the calculation is not clearly set out based on observable market prices) or the provision of operating crew that are likely to require significant judgment in distinguishing between service and lease components and allocating payments. Whilst this requirement is not new the accounting implications of identifying service contracts versus leases are likely to be greater.

Lessors may also see increased requests from lessees to restructure their existing leases or to structure new arrangements so as to include more service components than lease elements, thereby reducing the grossing up of their balance sheets and leverage. The proposals could give rise to more fundamental changes to the leasing sector, whereby lessees request provision or access to an asset (aircraft) with particular specifications or characteristics, which may be sourced from a common pool of such assets, thereby changing the arrangement to being more of a service than a lease – such arrangements would likely favour larger lessors who might be able to facilitate such arrangements, and airline groups or alliances who share aircraft types/configurations and could benefit from such arrangements.

Likelihood of Impact	Potential Impact
Low	High

8. Requirement for additional disclosures

Proposal

The lessee would be required to present or disclose its lease liabilities separately from other financial liabilities. The right-of-use assets would be presented or disclosed separately from property, plant and equipment that the entity does not lease. The amortisation of the right-of-use asset and the interest expense on the lease liability would be required to be presented separately from other amortisation and interest expense. Similarly, lessors would be required to present lease receivables separately from other financial assets and the residual assets separately within property, plant and equipment.

For leases featuring accelerated expense recognition, payments of principal would be presented as financing activities, payments of interest would be presented as either operating or financing activities, and payment of variable amounts would generally be presented as operating. Lessors would be required to show all cash payments under leases as operating cash flows.

Aviation industry implications

Lessee (airline industry) implications		Lessor (aviation financier) implications	
The requirements above are more detailed and may be more onerous to apply than the current requirements in relation to finance leases that are recognised on the balance sheet or indeed current off-balance sheet operating leases.			
The separate recognition of the right-of-use asset for aircraft in particular may be confusing to users of the financial statements.		Lessors may expect that the quantum of lease receivable balance may increase focus of users more towards credit risk associated with lessees rather than asset risk associated with assets (aircraft). Lessors may be required to provide, and users may seek information about concentration risk, geographical dispersion and expected periods of recovery of lease receivable balances.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High

9. Introduction of new terminology and thresholds specific to leases

Proposal

The exposure draft includes a number of terms that have not previously been used under IFRS or US GAAP. These include:

- significant economic incentive;
- threshold tests; and
- right-of-use asset.

Aviation industry implications

Lessee (airline industry) implications	Lessor (aviation financier) implications
The current IAS 17 and ASC 840 terminology and classification criteria relating to finance/capital leases and operating leases are well understood by preparers and users of financial statements. There is a risk that introducing new, additional terms may create unnecessary complexity.	
Likelihood of Impact	**Potential Impact**
Low	Low

Do you require further assistance in dealing with the Leases ED?

KPMG is a leading advisor to the aviation industry. We are well positioned to help you understand the potential impacts of the Lease ED on your business.

Financial and organisational considerations

Three key questions that many aviation organisations will be asking themselves are:

Key questions for lessees and lessors

Will lease accounting be a fundamental change for me?	Are my systems and people up to the task?	How will the new requirements affect leasing products?
Key factors to consider in response to questions		
• The impact of all leases (except short term leases on the balance sheet (for lessees). • Likely impact to your future profitability. • The affect to gearing and loan covenants (for lessees) • Possible impact on capital (if lessee is a financial institution).	• The quantity and quality of data required to assess and calculate your accounting numbers. • Whether to change your current system or application to perform the lease accounting calculation. • How current lease accounting may be affected by new lease classification criteria and judgements.	• Whether you require assistance to assess the decision to buy or lease. • Whether renegotiation on existing lease arrangements is required. • The tax implications of the new requirements.

KPMG provides a framework for dealing with this accounting change. In addition, KPMG has developed a Web-based tool to assist organizations with their preparedness activities and eventual adoption of the new leasing standard. The tool can help companies make the conversion to the new lease accounting standard more efficient. The Web-based tool is hosted in our private cloud allowing for easy maintenance and future upgrades. In addition, by allowing KPMG to host the tool, companies will be provided with greater efficiency and flexibility in terms of data storage, processing, and security. KPMG can also offer companies the option to install the tool within their IT environment through a licensing agreement.

Tax Considerations

The proposals may have significant impacts on the tax treatment of leasing transactions in many jurisdictions, in particular in those where the treatment for tax purposes is often based on or follows the accounting principles. As there is no consistent leasing concept for tax purposes globally, the effect of these proposals will vary from jurisdiction to jurisdiction, and the likely impact that the proposals may have will similarly vary from jurisdiction to jurisdiction.

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To discuss this further, contact your KPMG team or the KPMG team in your geography listed in this brochure.


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