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The British Helicopter Association's comments on the IFRS Exposure Draft ED/2010/9 – Leases

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The British Helicopter Association (“BHA”)

The British Helicopter Association was formed in 1969 and is the Trade Association that represents the interests of nearly all UK commercial, private, corporate, business, Police, Air Ambulance and Helicopter Emergency Medical Service operators and their associated suppliers and service providers.

The Association has some 220 members and is financed by member subscription as a non-profit making organisation that is limited by guarantee. It has strong links with the European Helicopter Association and the Helicopter Association International.

Helicopters and Leasing

Helicopters have some features which make them ideal candidates for operating leases, conditional sales, hire purchases and finance leases.

1. They have long lives – some commercial medium and heavy helicopters fly for over 40 years.
2. Many helicopters, especially the larger ones, hold their values very consistently, so that many helicopters will be worth 75% of original cost after 10 years and often 50% after 25 years, even in low inflationary times. Most helicopters built in the 1970's and still flying are worth more than their original cost in nominal terms.
3. They are easily transportable all over the world and so have a large potential market for secondary sales.
4. There is a clear re-sale market for disposal at the end of leases.
5. Title and financial interests can be easily registered.
6. Sustainable values make them good candidates for asset based finance.

BHA cites these facts merely to illustrate that there is a solid foundation for the facts that are given in its comments on the Exposure Draft.

Helicopter operators either acquire their assets through purchase and ownership or through conditional sales, instalment purchases or finance and operating leases. Often the reasons for preferring one method to another will relate to legal and tax considerations. A preference for operating leases is driven mainly by the wish to transfer risk, particularly value risk, to the lessor or other third parties.

Comments on the Exposure Draft

BHA's response to the Exposure Draft has been drafted by one of its associate members, Sheldon and Partners, an adviser to the industry responsible for arranging about \$1.8billion worth of operating leases, conditional sales, hire purchases and finance leases over the last ten years for various members of the BHA and for other helicopter operators round the world.

In the course of its work it has come across the different lease accounting rules of most of the OECD countries and has had extensive experience in dealing with lease accounting standards covered by FAS167 (and the preceding US standard outlined in FIN46(R)) and other EITF's in the US.

BHA's Board has adopted the draft as its own comments and recommendations.

Overall Response

1. Acceptance of the fundamental principles of the Exposure Draft

As was stated in its response last year to the initial Discussion Paper, BHA accepts the fundamental conclusions outlined in the Exposure Draft.

These are that there should be an end to the often minimal distinction between finance and operating leases where the difference of 1% in the degree of commitment could determine whether or not the whole cost of an asset appeared on a lessee's balance sheet.

BHA accepts that it is right that what should appear on a lessee's balance sheet is the discounted present value ("DPV") of a lessee's committed obligation –the "right of use".

Members of the Association who give financial covenants to lenders have tended to find that lenders adjust total debt to include the DPV of committed rentals streams in any event. The methodology used for many years to establish “Adjusted Debt” by the leading rating Agency, Standard and Poor’s, and applied to some of our members is remarkably similar to that proposed in the Exposure Draft. In this respect, the main proposal in the Discussion Paper is merely catching up with what Lenders, Rating Agencies and Creditors have been doing for a generation.

2. Acceptance of the probability approach to lease extension rights, asset value guarantees and contingent rentals

Although BHA in its response last year felt that the probability approach to lease extension rights, asset value guarantees and contingent rentals was overly judgemental and complicated, it now accepts that it is the only approach that avoids a so called “bright line” test – the avoidance of which is the basic philosophical approach of the new standard.

3. Purchase options

Last year, BHA had felt that it would be wrong to try to include purchase options in the new standard because it would inevitably have led to an all or nothing (“bright line”) distinction and because it might lead to double counting. The value of any bargain in a purchase option will in any event be reflected in the right of use balance because, ipso facto, the lease rentals will have amortised the capital balance to a point below fair market value.

BHA is therefore pleased that the new standard will exclude purchase options unless and until they are exercised. It is felt that this has to be the right approach. (The consideration of purchase options as part of distinguishing between leases and purchases is discussed below.)

4. Distinction between leases and purchases

The one remaining area where BHA believes the approach in the Exposure Draft is both unnecessary and wrong is in the delineation between the treatment of leases which are deemed effectively to be purchases and all other leases.

It is felt that this distinction introduces a complicated bright line test where none is needed.

The difference between the accounting treatment of an outright purchase and a lease where little risk has been transferred is in any case very small. For example, a simple lease where the lessor amortises to a 10% residual value over say 8 years would lead to a Right of Use on the balance sheet of approximately 95% of the asset cost. The need for a time consuming judgemental test to decide whether 95% Right of Use or 100% cost of a purchased asset should appear on the balance sheet is not at all clear.

The whole philosophical point of the new standard is to replace bright line tests with a gradualist approach. It does not seem sensible to abandon this principle over the last 5% of what is otherwise a carefully graduated system.

This is BHA's only remaining comment. The remainder of this response examines in more detail the case for abolishing this remaining bright line test.

The Bright Line distinction between Leases and Purchases

The relevant references in the Exposure Draft are paragraphs BC55 to BC58.

The amount of interpretative commentary already written by leading accounting firms on just these 4 paragraphs illustrates just how difficult this distinction will be. If the end result were momentous then it could be worth the difficulty, but the difference between having and not having this distinction will be minimal in accounting terms.

It could also be said that the distinction will be thoroughly misleading in legal terms to readers of accounts. There is little difference between showing a purchase of 100% and a right of use of 95% of the cost of an asset on a balance sheet. There is however an enormous legal difference between an asset that is owned outright and one whose ownership resides with a third party. In the first case there is a huge legal process to be gone through before an owner can be deprived of his asset. In the second case, the "would be" owner has to have performed all its material legal obligations before it can finally acquire title.

BHA believes that the distinction between purchases and lease should be on the basis purely of title. Previous accounting definitions of what should constitute a purchase will cease to have the same relevance when the accounting standard anticipated by this Exposure Draft comes into effect. Far from the authors of this Exposure Draft having to take note of other standards defining purchases, BHA believes that the authors of those other accounting standards should adapt to this one.

Detailed commentary (using the relevant extracts from the Exposure Draft)

Distinguishing between a lease and a purchase or sale (paragraphs 8(a), B9 and B10)

BC59 The requirements in the exposure draft would apply to transactions in which one entity transfers to another the right to use an underlying asset. They would not apply to transactions in which control and all but a trivial amount of the risks and benefits associated with the underlying asset are transferred at the end of the lease term, because such transactions do not meet the proposed IFRS. Such transactions are purchases or sales within the scope of other IFRSs and US GAAP, in particular IAS 18 *Revenue* and Topic 605, Revenue Recognition.

BHA agrees that the standard should apply to all asset financings where title is transferred from the user to a third party owner. In these financings, the user may or may not have the right to take title subject to fulfilling a number of conditions.

However, BHA thinks that the second sentence above flatly contradicts the first and it certainly disagrees with it. (It is in any case a tautology because the relevant transactions will meet or not meet the proposed IFRS depending on the results of this Exposure Draft).

Some simple examples will illustrate BHA's point.

Common assumptions in the following examples are an asset costing 100, a financing period of 8 years, a lessee marginal borrowing cost of 9%pa (which also happens to be the IRR of the lease – a fact which may or may not be discernible to the user) and an asset whose fair market value is predicted ab initio to be 75 at the end of the 8 year financing.

1. User pays a lease rate of 0.93 per month and has no rights to purchase. Initial right of use balance to be amortised over 8 years would be 63.4.
2. As in 1, but user has a right to buy for 75 at the end of the lease. Initial right of use would be unaltered at 63.4.
3. User pays 1.39 per month and has a right to buy for 10 at the end of 8 years. Initial right of use would be 95.12.
4. User pays 1.39 per month and is compelled to buy for 10 at the end of 8 years. Initial right of use would be 100, because the 10 would be considered to be simply a final payment.

Example 4 is a conditional sale. To own the asset, the user must perform all elements of its contract. In accounting terms the amount on the balance sheet is identical to a purchase. In legal terms, however, it is important that readers of the accounts are aware of the fact that the acquisition of title is conditional. Thus in terms of balance sheet classification, BHA believes that the asset sits more properly in the right of use category than in the owned category.

Example 3 is an operating lease where all but 10% (4.88% in present value terms) amount of the risk and reward is with the user. BHA cannot understand what is wrong with showing the slight 4.88% differentiation from an outright purchase. A huge amount of accounting resources will be spent needlessly on deciding where the dividing line between trivial and non-trivial lies. For example, if it is decided that a transfer of 20% (9.76% in present value terms) is enough, but of 19% is not, then there is a reversion to a needless bright line test.

Example 1 needs no comment. It is and always has been a pure operating lease, as has Example 2, with rare exceptions. The interesting point, however, is that the present value of the “bargain” in the bargain purchase option in Example 3 is of course always going to be equal to the difference in rentals between Example 2 and Example 3. $65(75 - 10)$ discounts to 31.72. $0.46(1.39 - 0.93)$ per month also discounts to 31.72.

Adding 31.72 to the right of use value correctly reflects the value of the bargain (which is why the Exposure Draft quite rightly avoids including the bargain purchase right again as a separate item because it will always already be included in the right of use value).

BC60 The boards propose that an entity should determine whether a contract transfers the underlying asset to another entity using the principles developed in their projects on revenue recognition and consolidation. Those projects propose that transfer of control is the determining factor in whether an entity transfers an asset to another entity. However, an entity assesses control of the underlying asset at both the start and the end of the lease.

Unfortunately, the apparently simple statement in B60 forms the basis of a real nightmare of judgmental accounting as anyone who has had the misfortune of having to deal with FAS167 will have discovered.

Reams of opinion have been expressed on what “control” means. It is as vague and unclear as it could possibly be. There is a school of thought in the US which says that there is a heavy presumption that the user has control because he can determine the material status of the asset (for example, for how many hours it is used during the lease – a factor which is wholly irrelevant for helicopters but may matter a great deal for a printing press). There are many other schools of thought!

BHA believes that the best result would be not to have to consider this at all and wonders what happened to the gradualist and gratifyingly simple philosophy behind the Exposure Draft in this respect.

BC61 In some cases, a transaction may not be described as a purchase or sale but may transfer control of an underlying asset (rather than a right to use the underlying asset) from one party to another. For example, an entity obtains control of a machine if the lease includes a bargain purchase option exercisable after five years. Thus, the transaction represents a purchase rather than a lease. Such transactions would not be included within the scope of the proposed standard, even if the contract is described as a lease.

It is already clear that BHA believes that the fundamental distinction is not control (whatever that may mean) but legal title, which forms the real the distinction between the owner and the user.

BHA has already shown that the bargain in the bargain purchase option will be properly recognized in the right of use balance. Why is there a need to use this element to create a new bright line distinction?

Again the problem is that there will be reams of opinion on what does and does not constitute a bargain purchase, representing another time wasting exercise for all concerned and an abandonment of the underlying principle behind the Exposure Draft. (For example, does a rebate of rentals based on sales proceeds amount to a bargain? Current accounting opinion is that it is if the user has any part in deciding the sale and it is not if he has no rights in this respect – the glory of the right of use calculation is that it is not necessary to make these distinctions – the present value of any kind of bargain is always recognised and put on the balance sheet).

BC62 Some respondents to the discussion paper were concerned that attempting to distinguish between purchases or sales and leases would reintroduce a classification requirement that would increase the complexity of the proposals. However, the boards think that purchases or sales and leases have different economic effects and that the accounting should reflect those economic differences, regardless of the way that the contract describes the transaction.

BHA feels that it has given very cogent reasons why the views of the “some respondents” should prevail.

BHA feels that the basic legal and economic difference lies in which entity holds title. This idea is simple and would leave the application of the Exposure Draft in an unadulterated form.

Conclusion

BHA hopes that the FAS and IAS Boards will take the above arguments very seriously.

Its members are more concerned by the complexity that has been introduced to the proposed standard than by the final outcome. One could stand BHA’s argument on its head and say that, if the difference between having the bright line tests on the lease/purchase distinction will rarely impact its members balance sheet by more than 10%, why make all the fuss?

The fuss is therefore principally an objection to the adulteration of a great advance in accounting principle and to the introduction of costly and unnecessary accounting workloads rather than a concern about the precise amount that will go on the balance sheet.

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