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Impairment considerations in aircraft leasing

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Impairment has always been a challenging and subjective matter. The continuing impact of Covid 19 means that impairment will be an area of heightened focus for the preparers, auditors and end users of financial statements (investors and others). Whilst some parts of this article may be relevant to other participants in the aviation industry, the primary focus of this article is the aircraft lessor sector.

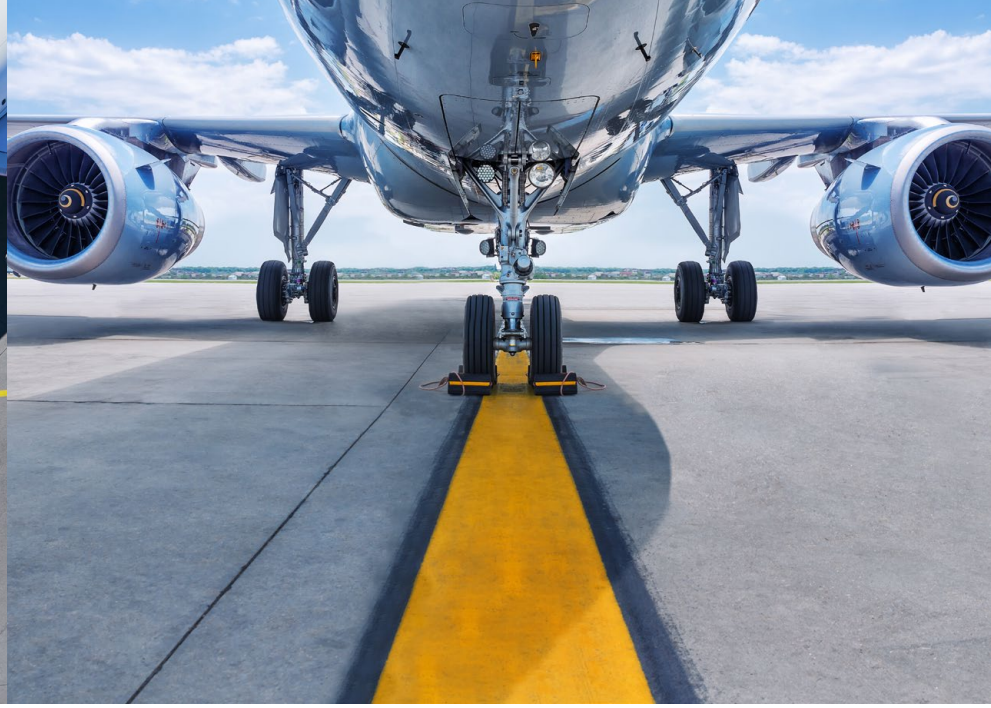
The dislocation of the aviation industry as a result of Covid 19 has been the subject of much discussion. The travel and leisure sector has seen vast changes within the past year and these have included a dramatic reduction in travel, an increasing number of airlines seeking bankruptcy protection or entering bankruptcy, most airlines seeking some sort of support arrangements from equity holders, governments, lessors, banks or in a lot of cases all of the above. The one bright spot in all of this negative news over the past 7 months was a seeming return in some areas to domestic travel to pre Covid 19 levels following an initial dramatic decline. As uncertainty around airline travel between regions and more localised lockdowns occur, even this area of positivity has seen some stagnation in recent times.

Whilst the impact of Covid 19 has been felt the most during 2020, the majority of companies have a calendar year end and so therefore these Covid 19 related issues weren't reflected in their 31 December 2019 financial statements, or to the extent they were, then usually only disclosed as a post balance sheet events. One of the most important points of Covid 19 as it relates to financial reporting and to impairment specifically is that the future is still very uncertain and an ability to predict what the next few years will look like is extremely difficult. Considering the conditions to date and the uncertainty of future conditions then it is no wonder that in this year, above all other years, impairment will have an even greater degree of focus from all concerned parties.

US GAAP vs IFRS

In order to consider impairment in a financial reporting context, one first needs to have an understanding of the requirements of the accounting standards on this matter. In that regard the two main accounting frameworks used in the industry are International Financial Reporting Standards ("IFRS") and US Generally Accepted Accounting Principles ("US GAAP"). Whilst both require a user to perform an impairment test there is quite a significant difference between the impairment test required.

Under US GAAP the key guidance in relation to impairment is to be found in "FASB ASC 360 Property, Plant and Equipment". Under this standard a long-lived asset such as an aircraft is considered impaired if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. This, in practice, is commonly referred to as the gross cash flow test. Where an aircraft fails the gross cash flow test then an impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.



Companies preparing accounts under IFRS have long argued that the impairment methodology under IFRS is more penal than that of its US GAAP counterpart. IAS 36 "Impairment of assets" defines the recoverable amount as the higher of an asset's fair value less costs of disposal and its value in use. In simple terms the IFRS test is broken down as follows:

Step 1:

Assess what the current market value of the aircraft is (generally in practice this has been done by reference to appraisal values).

Step 2:

Calculate the value in use of the aircraft discounting the expected future cashflows back to a present value using a discount rate that reflects a market participant's view of the risk associated with that particular aircraft.

Step 3:

Using the highest answer from Step 1 and Step 2 compare this to the carrying value of the aircraft.

The key difference between the frameworks is therefore that under IFRS a discount rate is required to be applied to the expected cashflows. As many aircraft are assumed to have useful lives of between 20-30 years at least, then the impact of this discount rate can be quite significant especially when it comes to discounting the large assumed residual value at the date of disposal. We discuss some of the key inputs in relation to the impairment assessment below.

Fair Value Considerations

In considering the above accounting, we shall firstly consider just what the fair value of an aircraft constitutes as many of the considerations surrounding the expected cashflows are similar under both standards. Just what exactly fair value is, has always been a source of differing views. Whilst everyone agrees to the idea that it is the value that one could expect to sell an asset at in an arm's length transaction to a third party, the actual calculation of that price has always been the subject of the discussion.

As noted previously, in practice, the fair value has generally been calculated by reference to independent appraisers or to transactions in the market. As most market participants will also know, the range in values between different appraisers can be quite large and this has been a common point throughout the years and is not just a new Covid 19 development. In the current year, however there are additional items that need to be considered when looking at the appraiser valuations being used in an impairment assessment. These include;

- Dislocation of market values. The effect of Covid 19 on market prices has been varied dependent on the type of aircraft with narrow bodies generally seeing less of a reduction than wide bodies. The subject of these valuations has been discussed at great length by the various appraisal firms who are the experts in this field and this article does not delve in depth into these areas again. However, it is clear to any user of appraisal based data that the current values have suffered a decline and in many cases the current value is now suppressed below the base value (the expected value in a normal market). In assessing fair value, one must look to the current value and therefore the values being used in the current year will include large decreases from prior year and will show aircraft with signs of potential impairment.
- Limited transactions. Given the effects of Covid 19, there has been a decrease in the level of sales types transactions within the marketplace. This has meant that there is less data within the market overall to compare prices against.
- Ability to complete a transaction. Covid 19 has without doubt placed some liquidity constraints on the market and investors in a number of cases have pressed pause or even stop on transactions whilst they wait to see what the market will look like. Therefore, whilst people may be in the market looking to complete transactions, a key issue is whether these transactions will complete especially if the negotiations were in the earlier part of the year.

The above whilst in no way an exhaustive list illustrates some of the key additional considerations that Covid 19 has generated in the context of trying to fair value an aircraft and need to be considered in completing any impairment assessment.

Cashflow model considerations

Due to the dislocation of the current market values from Covid 19, it is expected that many aircraft will be tested using a cashflow model test. The projection of cashflows has always remained a key audit focus area and a key area of management judgment and will be even more so in the current year. As noted previously the main essential difference between the cashflows under IFRS and US GAAP is the inclusion of a discount rate under IFRS. We will discuss this discount rate later but firstly we will focus on some areas within the cashflow model that are relevant to both IFRS and US GAAP. These include but are not limited to;

- Expectation of contracted cashflows being received. In compiling a cashflow analysis the first thing to do previously was to include the current contracted cashflows on the underlying aircraft. The current crisis has meant that many airlines are struggling with cashflows and will probably suffer more during the winter months than they have previously experienced. Allied to this, is the fact that it is unknown when airlines will return flying at pre Covid 19 capacity and revenue yield levels. Owing to this uncertainty there is therefore a greater emphasis on whether the current lease rates under the contract are collectible and/or if scenario analysis needs to be performed on these cashflows reflecting this uncertainty.
- Future assumptions. Any cashflow analysis is likely to include numerous management judgments related to the future cashflows associated with aircraft. In respect of the lease cashflows it is therefore necessary to make assumptions around downtime between leases and cashflows that will be available once the aircraft is placed on lease. At present this is very difficult to assume as there is less demand for aircraft, less usage of aircraft and lease rates are depressed with a number of leases having been restructured to power by the hour type deals or including payment deferrals of contracted lease rates.
- Residual values. As part of any cashflow, one must assume a date of sale and a sales value. At the minute the base values have not seen any material changes in a number of types of assets, but this may be subject to change in the future if the effects of Covid 19 continue to occur and/or occur for longer than anticipated. In addition anyone who had anticipated sales in the near future may now be reconsidering these sales because there may not be an opportunity to sell at what is seen at an appropriate sales price.

In addition to the above considerations, IFRS also requires that the discount rate is calculated and applied to the expected cashflows. The discount rate is set to reflect a market participant view of the risk associated with the asset and its cashflows. This has always been a very judgmental area of any calculation and it is especially true in the current year. In looking at an appropriate discount rate in the current year, preparers of financial statements will have to account for the fact that there is without doubt an increased level of risk associated with aircraft as an asset type. There may also be a different level of risk associated with different classes within the asset type and different levels of risks associated with different lessees. All in all what was already a highly judgmental and subjective areas has become even more so in the current climate.

Overall consideration

The question that we continually hear considering all of the above is so what does this mean for a preparer, auditor and user of financial statements in the current year. Essentially it means that there will be more detailed analysis required around the key judgment areas included in the impairment assessment, most likely that there will be a number of scenarios included within this assessment as a one case fits all scenario is unlikely to hold true and there will need to be enhanced disclosure in the financial statements around the management judgments made. Overall what was an already complex and subjective area will be even more challenging and complex in the current year.

The above article is not set to be a comprehensive discussion around the valuation of aircraft in the current market or on the individual judgments that each preparer of financial statements will encounter in completing their assessment but instead is meant to give some insight into key themes that we are seeing in the current year.

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