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Joint IASB/FASB Project on Leases – Applying the right-of-use model to lessors

Dear Ms Knubley,

EADS appreciates the opportunity to comment on the Boards tentative decision taken at their meeting in May 2009 with respect to lessor accounting. EADS is a global leader in aerospace, defence and related services. Through our 100% share in Airbus, we are a leading manufacturer of commercial aircraft, and as such, frequently enter into sales financing transactions and leasing arrangements, principally as lessor.

We have noted that in regard of the two approaches (Approaches A and B) proposed in the Discussion Paper on Leases for applying the right-of-use model to lessors, the Boards supported Approach B at their meeting in May 2009 and tentatively decided that a lease contract creates a new right and new obligation for the lessor (instead of resulting in a transfer a portion of the leased asset, as would be the case under Approach A).

We are concerned that Approach B may be conceptually flawed and would tend to result in accounting for the same asset twice. Specifically, our concerns are as follows:

1. Under Approach B, the lessor continues to control the (entire) leased asset, which seems inconsistent with the Boards' preliminary view that the lessee controls the right to use the leased asset for the lease term.
2. Under Approach B, the lessor's leased asset and its lease receivable embody the same future economic benefits, so recognizing both simultaneously would result in the same 'benefits' being recognized as assets twice.
3. Under Approach B, the rationale for recognising a receivable conflicts with the rationale for recognising a performance obligation.

These issues are further explained in 1. to 3. below.

We are also concerned that the decision in favour of Approach B may have been partly influenced by the revenue recognition pattern introduced for the derecognition approach (Approach A). Although situations in which sales revenue might be shown at inception of the lease are discussed in a separate section of the May 2009 *IASB Agenda Paper 11 (AP 11)*, the

illustrative journal entries provided in the Appendix to the paper (in AP11A.5), indicate that Approach A will give rise to interest income, but otherwise have no effect on the income statement. As a result, the Appendix might be read to imply that under Approach A, only the financing activity will be reflected in the income statement, whereas production activities performed prior to lease inception will never be recorded (or only to the extent that revenue may eventually be derived from the sale of the returned leased asset).

We think that for a manufacturer-lessor it would be more appropriate to have its production activities be reflected in the income statement as well (by recording revenue and cost). Under Approach A, this could be achieved by the lease receivable being recognised through a credit to revenue, and the transferred portion of the leased asset being derecognized through a charge to CoS (with any difference being accounted for as the manufacturer's profit or loss). Interest income would be subsequently recognized as illustrated in AP11A.5. We think that amending Approach A to provide an accounting model for manufacturer-lessors that includes the recognition of revenue and cost (while retaining the model proposed in AP11 for direct financing leases) will enhance the decision usefulness of the information to be derived from the income statement. This is because such an amendment, by recording both financing and production activities in the income statement, would better reflect the economics of a manufacturer-lease.

Put differently, our suggestion would be for the Boards to reconsider Approach A while exploring the possibility of retaining the current distinction between sales-type and direct financing leases.

With respect to Approach B, we think it may be conceptually flawed for the following reasons:

1. Under Approach B, the lessor continues to control the (entire) leased asset, which seems inconsistent with the Boards' preliminary view that the lessee controls the right to use the leased asset for the lease term

With respect to lessee accounting, the Boards have taken the preliminary view that the right to use a leased item is an asset, given that (among others) "the lessee controls the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of the lessee (or breach of contract)" (DP Leases.3.16). At the same time, paragraph 32 of AP11 (and DPLeases.10.17) argue that under Approach B "the lessor does not lose control of the leased property for the lease term and thus continues to recognize the leased item". It is not apparent how the lessor may continue to control the leased property (in its entirety), if it no longer controls the right to use the leased property (at least for the lease term).

We think the two propositions may only be reconciled if it is argued that control of an asset and control of the right to use an asset are two things apart - in which case, there may be one party that controls the asset, and another that controls the right to use the asset. However, we

currently do not see on what basis control of an asset may be effectively separated from control of the right to use it.

2. Under Approach B, the lessor's leased asset and its lease receivable embody the same future economic benefits, so recognizing both simultaneously would result in the same asset being recognized twice

The IFRS Framework requires that future economic benefits are expected to flow to the entity for the definition of an asset to be met. We note that under Approach B, the 'future economic benefits' to be derived from (1) the lease receivable and (2) (part of) the leased asset are identical—in both cases, these benefits will materialize in the form of the lease payments. We think that a specific amount of future economic benefits should not be reflected twice on the balance sheet (by giving rise to both a lease receivable and a leased asset).

We note that under Approach A, this form of 'double accounting' for essentially the same asset does not occur (as the recognition of a receivable is accompanied by the derecognition of (part of) the lease asset).

3. Under Approach B, the rationale for recognising a receivable conflicts with the rationale for recognising a performance obligation

Paragraph 15 of AP11 (and DPLases 10.11, which implicitly applies to Approach B as well) argue that the lessor's right to receive payments from the lessee meets the definition of an asset, once the leased item has been delivered to the lessee. The delivery of the leased item to the lessee is identified as the past event that gives rise to the lessor's— unconditional—right to receive payments. The rationale for considering the right to receive payments to be unconditional (and hence for allowing, or requiring, a receivable to be recognized) seems to be that the lessor has essentially performed its part of the contract (so the right to the lease payments is no longer contingent on lessor performance).

Paragraph 33 of the AP11 (and DPLases 10.18) state that the lessor has retained an obligation to provide the use of the leased asset to the lessee over the lease term. We think this view may not be reconciled with the analysis above. For either the lessor's right to receive payments is unconditional, in which case the lessor should not retain any performance obligation with respect to the receivable, or the lessor actually continues to be obliged to perform, in which case the right to receive payments is not unconditional but contingent to the extent that performance has not taken place.

AP11 (and the DPLases) attempt to solve this inconsistency by arguing (in paragraph 34 or 10.19) that "once the leased item is delivered to the lessee and the lessor has begun its performance" the right to receive payments has become unconditional. We consider this argument to be fallacious, because it fails to recognize that (at least some of) the payments remain contingent upon the lessor performing those activities which it has only "begun" to

perform. Performance cannot both be complete (giving rise to an asset for the unconditional right to receive payments) and incomplete (giving rise to an obligation to perform).

It might conceivably be argued that performance is partially complete. For example, the lessor's performance obligation might be considered twofold, consisting of (1) delivery of the leased assets and (2) providing use of the leased asset. We do not agree with this analysis, but even if it were tenable, it would not justify recognizing a receivable for **all** the lease payment (as proposed in Approach B)—what could be justified under such an analysis is recording a receivable for only that portion of the payments for which the lessor has already met its performance obligations.

Paragraph 34 of AP11 (and DPLEases 10.19) go on to state that "the lessee has an unconditional right to use the leased item because the lessor has no contractual rights to recall the item from the lessee" (unless the lessee breaches the contract). This seems to be taken as further evidence that the lessor has an unconditional right to receive payments. We agree that the lessor has an unconditional right to receive payments if the lessee has an unconditional right to use the leased item— however, we do not agree (and neither AP11 nor the DPLEases provide any support for the view) that, at the same time, the lessor continues to have a performance obligation. Instead, the reason given in AP11.34 for the lessee's right to use the asset to be unconditional, namely that "the lessor has no contractual rights to recall the item from the lessee", appears to support the view (rather than refute it) that the lessor already has effectively provided use of the asset to the lessee and so has discharged (all of) its performance obligations.

Again, we note that under Approach A this inconsistency does not exist, because a performance obligation is not recognized.

We would greatly appreciate your views on the issues raised and be happy to answer any questions you might have.

Yours sincerely,

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Vice President

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