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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing in Austria, I appreciate the opportunity to comment on the Discussion Paper *Preliminary Views of Leases* (January 2009). Principal authors of this comment letter were Peter Geyer, Gerhard Marterbauer (Chair), Aslan Milla, Michael Komarek, Harald Podoschek and Günter Schmidt.

General remarks

We are pleased that the IASB is preparing to revise the provisions governing lease accounting, because in our opinion IAS 17 leaves too much room for alternative interpretations, and the elimination of these should lead to an improvement in the usefulness of financial statements. We are however concerned that the approach outlined in the Discussion Paper means that different kinds of transactions will be treated in the same way. In our view there is a fundamental difference between lease contracts in which the primary consideration is financing of investments and those where the ongoing short term use of an asset is the principle concern. We would have been in favour of removing the weaknesses in the old standard, particularly with respect to the accounting treatment of operating leasing, instead of creating an entirely new standard. We support the IASB's proposal to account in future both for the future obligations of operating leases and for the benefits from use of the assets. On the other hand, it would in our opinion have been advantageous to treat leases providing for the

short-term use of assets differently to long-term leases that are essentially intended to finance the assets. For leases intended primarily to provide short-term use of assets, spreading the costs evenly and presentation as part of operating expense – as for rental agreements – would in our view have been more appropriate than the diminishing balance method now applied to finance leases, where the expense per period diminishes over the period of the lease contract and interest and depreciation expense are presented separately.

Specific comments

Q1. *The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.*

We see no need for any extension of the scope of the new standard. We consider it reasonable to continue to deal with special topics such as accounting for the exploration for and evaluation of mineral resources in separate standards. However, exceptions to the new standard should only be permitted where there are clearly applicable provisions in other standards.

Q2. *Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.*

Since the proposed regulations exhibit a high degree of complexity, the desire to make exceptions for non-core leased assets is understandable, especially in the light of the necessary balance between benefits and costs in the application of accounting rules discussed in the Framework. We are however of the opinion that in many cases the requirement to distinguish between core and non-core assets will result in considerable problems. We are also concerned that it may result in the creation of another 'bright-line', replacing the distinction between operating and finance leases with that between core and non-core assets. For these reasons, we consider that the new standard should not only be applicable to core assets.

Q3. *Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree explain why.*

There are no objections to the basic right-of-use model, although we would draw attention to the identical treatment of different kinds of transactions, mentioned under General remarks, above.

Q4. *The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:*

- (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)*
- (b) a liability for its obligation to pay rentals. Appendix C describes some possible accounting approaches that were rejected by the boards.*

Do you support the proposed approach?

If you support an alternative approach, please describe the approach and explain why you support it.

There are no objections to the basic right-of-use model. We would however argue in favour of proceeding differently with lease contracts that constitute in-substance purchases (lease purchases), since there is no material difference between lease purchases and purchases on credit. This view is also shared by several FASB members. In our opinion there is generally a in-substance purchase if the lease contract provides for an automatic transfer of ownership. The assets that theoretically are leased but in practice are purchased should be recognised as the lessee's own assets, and the related liabilities should be subject to the same regulations as under the usual provisions governing financial liabilities.

Q5. *The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:*

- (a) a single right-of-use asset that includes rights acquired under options*
- (b) a single obligation to pay rentals that includes obligations arising under contingent rental agreements and residual value guarantees.*

Do you support this proposed approach? If not, why?

Given the difficulty of implementing component approaches, the decision in favour of disclosure of a single asset is to be preferred, even though such an approach is atypical for IFRSs, which usually support a component approach (IAS 16, Embedded Derivatives, etc.).

Q6. *Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?*

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

In the Discussion Paper it is assumed that for the initial recognition of the leasing liability the theoretically correct interest rate – the rate implicit in the lease – should be used to discount the leasing payments. However, since in the boards' opinion the incremental borrowing rate is easier to calculate than the rate implicit in the lease, the incremental borrowing rate should be used to discount the future leasing obligations. In the Discussion Paper the incremental borrowing rate is defined as follows: "the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term and with a similar security, the funds necessary to purchase the asset."

We endorse the view that it is methodologically more correct to use the rate implicit in the lease to discount the leasing obligations. In our opinion there are very many lease contracts, particularly where finance leasing is involved, where there are no practical problems with calculating the rate implicit in the lease, since the lessor's calculation is known to the lessee. In addition, there are methodological problems in calculating the incremental borrowing cost. It is not clear why it should be simpler to ascertain the implicit rate of a comparable lease than the implicit rate of the actual lease in question. There are also practical difficulties in establishing the rate of interest that the lessee would pay on a loan with comparable terms and securities, since the legal position of a lessor is different from that of a creditor of a financial liability. For real estate leasing, it is true, a mortgage loan could if required be used for the purposes of comparison, but for movable property there could be no legal position for a lender comparable with that of a lessor, since in Austria there is no possibility for a lender to acquire a collateral security on movable property. On top of which, in the case of a mortgage there would be registration fees to be taken into account. In our view, therefore, it is in many cases just as difficult to establish a discount rate corresponding to the definition of the incremental borrowing rate in the Discussion Paper as it is to determine the rate implicit in the lease.

There would also be differences between the lease repayment schedules and the liabilities to be disclosed in the financial statements, which would result in added complexity for the lessee in measuring leasing liabilities.

We therefore support the use of the rate implicit in the lease for discounting the leasing payments, as hitherto, and suggest that the incremental borrowing rate should only be used when the implicit rate cannot be determined.

Q7. *Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?*

If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

We see measurement at cost as reasonable, because the right-of-use assets are non-financial assets, and measuring non-financial items at cost is consistent with existing IFRSs.

Q8. *The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach?*

If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

We concur with the IASB's opinion that subsequent measurement of both the obligation to pay rentals and the right-of-use asset should be on an amortised cost basis.

Q9. *Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.*

To permit an alternative treatment to measure leasing obligations at fair value is not reasonable in our view, because under IAS 39 the application of the fair value option is primarily permissible if it eliminates or significantly reduces an accounting mismatch. This is unlikely to be the case with leasing.

Q10. *Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.*

If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash-flows? Please explain your reasons.

Periodic adjustment of leasing obligations to reflect changes in the incremental borrowing rate would essentially be equivalent to subsequent measurement of the leasing obligations at fair value. Since in our view – as explained in the answer to Question 9, above – this is not appropriate, we are against regular remeasurement to reflect changes in incremental borrowing rates.

Q11. *In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.*

Do you agree with the proposed approach taken by the boards?

If you disagree, please explain why.

Even if the obligation to pay leasing instalments has the characteristics of a financial liability as defined in IAS 39, it would still appear to be reasonable – given the contractual link between the liability and the right of use – to regulate the measurement of the liability independently in the new standard and not only to refer to IAS 39. Given the peculiar character of leasing liabilities, they should also be presented separately.

Q12. *Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.*

Would you support this approach? If so, for which leases? Please explain your reasons.

We think that separate presentation of interest expense and depreciation of right-of-use assets is reasonable where the emphasis is on the long-term use or on financing of the assets, because wear and tear and financing of the assets is thus more clearly presented. Where the emphasis is on the short-term use, we see presentation as rental expense as part of operating results as being more appropriate, for the reasons given under General remarks.

Q13. *The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.*

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We do not agree with the proposed approach. In our view it would be more reasonable to take only contractually fixed terms into account for measurement purposes, otherwise there will be too much manoeuvring room for the preparers of financial statements. Only in exceptional cases – where economic constraints or other de facto obligations justify the assumption that the option to extend will be exercised – should the additional period of the option be taken into account in measuring the leasing liability. An example of such an exception might be a renewal option on favourable terms, so that the rate implicit in the lease is lower if the option is exercised than if the option is not exercised. Another example would be where a leased asset is subleased for a period longer than the minimum period of the head lease, where the assumption must be that any option to extend the head lease must be exercised.

Q14. *The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.*

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

As explained in our answer to Question 13, we are of the opinion that the leasing liability should in principle be measured taking only the contractually fixed term into account, and only in exceptional circumstances should options to extend the lease term be considered. For the same reason, reassessments of the lease term should only result in revaluation of the leasing liability if the lessee has

incurred a contractual obligation, or if some other event has occurred that makes a change in the term of the lease reasonably certain.

Q15. *The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.*

Do you agree with the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

In our opinion purchase options are in principle to be treated similarly to extension options. We believe that a bargain purchase option has principally the same economic consequences as a bargain renewal option over the remainder of the assets's life and that in both cases the expected future cash flows should be included in the measurement of the leasing asset and the leasing liability. Furthermore we believe for the reasons given in the answers to Questions 13 and 14 that only bargain purchase should be taken into account in measurement.

Q16. *The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental agreements.*

Do you support the proposed approach?

If you disagree with the proposed approach, what alternative approach would you recommend and why?

In our view it is correct to include contingent lease payments as part of the liability. If the conditions are satisfied and an unconditional payment obligation arises, there is under all circumstances a liability. The question is not whether a liability exists, but how to measure it.

Here we would also like to draw attention to the problem that with lease contracts where the contingent leasing payments depend, e.g. on future revenues (sales), the fundamental principle of accruals-based allocation of income and expenses is breached. The inclusion of the contingent lease payments in the measurement of the liabilities and the right-of-use assets might result in high depreciation charges matched by little income, so that there is a disproportionate burden on the early parts of the lease period. In addition to which, there is the question of measurement by the lessor, who finds it even more difficult than the lessee to estimate leasing instalments that are not based on indexes or market data.

Q17. *The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.*

Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Even though we acknowledge the advantages of measuring leasing liabilities on the basis of weighted probabilities in circumstances where, for example, there are high potential payments combined with low probabilities of occurrence, we still prefer the approach of using the most likely value for measurement. Our reasons are on the one hand the complexity of using probability-weighted measurement procedures, and on the other hand the fact that liabilities calculated in this way correspond to the actual obligation only in exceptional cases.

Q18. *The FASB tentatively decided that, if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.*

Do you support the proposed approach? Please explain your reasons.

We are of the opinion that – to the extent available – forward curves should be used to measure the leasing liabilities, since this reflects market expectations of how the underlying values will change. If no forward curves exist, in certain situations it might be reasonable to use averages of past rates or indexes.

Q19. *The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.*

Do you support the proposed approach? If not, please explain why.

Where changes in circumstances lead to changes in expected cash flows, in our opinion remeasurement of leasing liabilities is required, for which reason we support the proposed approach. The remeasurement should however make use of the interest rate that was applied for initial measurement of the leasing liability at the inception of the lease. If the remeasurement of leasing liabilities were also to reflect changes in interest rates, it would be possible that even minimal changes in the expected cash

flows could lead to massive changes in leasing liabilities, which in our view would allow undesirable manoeuvring room.

Q20. *The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:*

- (a) recognise any change in the liability in profit or loss, or*
- (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.*

Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

In IFRIC 1 the IASB has ruled that changes in existing decommissioning, restoration and similar liabilities must be added to or reduced from the costs of the relevant assets in the current period, so that matching adjustments to asset and liability items not affecting profit or loss are not unknown. In our opinion, however, a remeasurement of the liability does not always entail remeasurement of the right-of-use asset, which is why we argue in favour of analysing in more detail in which situations adjustments of leasing liabilities should be through profit or loss, and in which situations they should not.

Q21. *The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.*

Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

AFRAC supports the proposed approach, because in our opinion residual value guarantees and contingent rentals are essentially the same from an economic point of view.

Q22. *Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.*

What additional information would separate presentation provide?

Since the recognition and measurement approaches proposed in the Discussion Paper differ considerably from the provisions applying to other kinds of liabilities, we would welcome the separate presentation of leasing liabilities. We consider it particularly to be recommended because the proposals in the Discussion Paper provide for frequent remeasurement of leasing liabilities; separate presentation would highlight the effects of remeasurement to users of financial statements in a transparent way. Should the IASB decide that this would be of no material advantage to users, then the relevant information should at least be required to be disclosed in the notes.

Q23. *This chapter describes three different approaches to presentation of the right-of-use asset in the statement of financial position.*

How should the right-of-use asset be presented in the statement of financial position?

Please explain your reasons.

What additional disclosures (if any) do you think are necessary under each of the approaches?

Some members of AFRAC prefer presentation under the asset category into which the asset falls, since this makes clear the nature of the leased asset. The argument supporting this approach is that leased assets are like purchased assets in that the right to use of the asset is always of prime importance. It would therefore be logical for purchased assets and leased assets to be disclosed under the same item. To make clear the different legal position of lessee and owner, there should also be a note attached showing the total amount of leased assets in each asset category. In the case of in-substance purchases (see Question 4), however, the assets should be disclosed as the enterprise's own assets.

Other AFRAC members argue in favour of presentation of right-of-use assets under intangible assets. Supporting this approach is the fact that the legal position of the lessee is less strong than that of a legal owner, so that separate presentation of owned assets and assets where there are only rights of use would be reasonable.

It would also be worth considering whether leased assets should be disclosed as a separate line item, although the question that this raises is whether in any given enterprise the volume of leased assets would be material enough to justify separate presentation.

It should also be pointed out that in the event of presentation as intangible assets there could be problems with the banking industry in connection with capital adequacy requirements for the purposes of Basle II.

Q24. *Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.*

There are serious concerns that the proposed changes in recognition and measurement rules in the Discussion Paper will make distinguishing between service arrangements and lease contracts, which is already difficult, even more problematic. Concern has been voiced that abolishing the distinction between finance and operating leasing will only result in new problems of classification

As explained in the General remarks, AFRAC has doubts as to whether it is reasonable to treat lease contracts where the short term use of assets is the important criterion in the same way as lease contracts where the financing of assets is the prime consideration.

Q25. *Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.*

Once the lessor has made the leased asset available to the lessee, the lessor has an unconditional right to receive the leasing payments. This right has all the characteristics of an asset: it is controlled by the lessor, since it is legally enforceable, it results from a past event, namely, the supply of the asset, and it represents future economic benefits.

Q26. *This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.*

Which of these two approaches do you support? Please explain your reasons.

In our view, under a lease agreement the lessor on the one hand acquires a new asset, namely the right to receive the leasing payments. On the other hand, the transfer of the leased asset means that the lessor also loses an asset, since for the duration of the lease contract control of the asset is lost, and the lessor is in essence left with the bare ownership without the right of use. We therefore endorse

se the derecognition approach, in which the leased asset is derecognised and only its future residual value, which is controlled by the lessor, is recognised as a future economic benefit in the lessor's statement of financial position.

Q27. *Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.*

In AFRAC's opinion it would definitely be reasonable to investigate revenue recognition for different types of lease agreements, since we believe that there are economic differences between banks as lessors, and distributors or manufacturers in the same role. We also see problems in revenue recognition for lessors if the regulations proposed for the lessee are also intended to be applied to the lessor. If contingent leasing instalments are taken into account in the measurement of leasing receivables, in our opinion the question then arises as to how any excess of the discounted expected leasing payments (including expected contingent payments) over the lessor's acquisition costs for the leased asset would have to be treated as revenue.

Q28. *Should accounting for investment properties be included within the scope of any proposed standard on lessor accounting? Please explain your reasons.*

In AFRAC's view, provided the rules proposed in the Discussion Paper are applied consistently there should be no need for cross-referring to IAS 40. The link up until now has been that a lessor was permitted to treat an interest in property which he holds under an operating lease as an investment property and carry it at fair value. In this context the changes in fair value of the investment property were primarily based on the changes of the expected rental or leasing income of the lessor of the sublease (who is the lessee of the headlease) over his future lease expenses under the head lease. Changes in the sales value usually do not affect the fair value of the investment property as the lessee of the head lease (who is the lessor of the sublease), which is an operating lease, usually does not have the legal position to benefit from these rewards. However, since the proposed regulations to be applied under the Discussion Paper in such cases in any event require ongoing remeasurement of the expected subleasing income, the sublessor's future benefits are correctly disclosed. Classification of a property interest as an investment property would appear not to be necessary. However, the discussions in the Discussion Paper of accounting issues affecting the lessor are too rudimentary to permit a conclusive assessment at this stage.

Q29. *Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.*

In the Discussion Paper the leasing accounting issues for lessors are very briefly discussed, but the boards have not yet expressed preliminary opinions as to how lessors should account for lease contracts. The boards' focus on lessees can be justified on practical grounds, and new accounting regulations for lessees appear to be more urgently needed, since past criticism of IAS 17 had largely focused on lessee accounting issues, but the members of the working group have the impression that dealing with leasing contracts from only one perspective (the lessees') is not reasonable. It is possible that the boards might have come to different conclusions on specific lease accounting issues with respect to lessees if they had considered lessor accounting at the same time. We hope that in all events the IASB retains its principles-based approach to accounting (substance over form).

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman