



**PRE – 070/10**  
December 15, 2010

**International Accounting Standards Board**  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

**Subject: Exposure Draft - Leases**

Dear Sir/Madam,

The ABRASCA - Brazilian Association of Publicly Held Companies - welcomes the opportunity to comment on the Exposure Draft named Leases.

We are an association which represents all the listed public companies in Brazil engaged, in this matter, in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian public companies.

This response summarizes the views of our public company members, which may be supported by the opinions of external parties, sent to us for analysis and to enhance the discussion on the subject matter.

If you have any questions about our comments, please contact the following email: [alexandre@abrasca.org.br](mailto:alexandre@abrasca.org.br).

Yours sincerely,

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## APPENDIX A - COMMENTS

### The Accounting Model

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#### Question 1: Lessees

- a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

#### Comments on Question 1

We strongly disagree with the “right-of-use” model for many reasons. In our opinion, the proposed model has the following inconsistencies and discrepancies:

- The determination on whether the contract is, or contains, a lease is unclear.
- Does not represent the view of the management and how the entity operations are managed.
- Is based on the form of the contracts.
- The unique issues of the oil and gas industry are not properly addressed (See our comment on question 5).
- The costs of implementation outweigh the benefits in relation to the information provided. Distinction between service and lease is burdensome, costly and complex to apply.

In the following paragraphs we are providing the grounds for our disagreement with the proposed model.

In our opinion the definition of whether or not a specified asset (subject to the recognition) is being provided should be based on the management view. In many circumstances the purpose is only contracting a service, notwithstanding the asset that will operate (“the asset will be a mere vehicle”).

Definitions of service and leasing should be provided in the explanatory notes, based on the company operations and view, rather than the narrow focus of a specified asset as proposed. The paragraph B3 creates a gray area related to the distinction between a lease and a service. Does the explanation provided represent that any “replaceable asset” is not considered a lease? Only assets specific designed for an entity is considered a lease?

Paragraph B3 of the ED states that:

“...A contract that permits an entity to substitute a similar asset for the specified asset after the date of commencement of the lease does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset...”

The boards (IASB/FASB) should pay particular attention to the need for users of financial statements to receive relevant and reliable information at a reasonable cost to preparers. Therefore, we strongly recommend that the future commitments related to both, service and lease, should be provided only in the explanatory notes based on company’s judgments. Only finance leases should be recognized in the balance sheet.

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In addition, we have noticed, however, something that seemed to be a discrepancy between the approach adopted in the proposed revenue recognition model and the right-of-use model. According to the Exposure Draft titled "Revenue from Contracts with Customers", if an entity performs it should present its contract with the customer as a contract asset. Nevertheless, an unconditional right to consideration should be presented as a receivable. We have not seen such distinction between receivables and lease assets in the leases' Exposure Draft.

## Question 2: Lessors

- a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?
- b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

## Comments on Question 2

We have the following comments on this matter:

- a) As explained in the Basis for Conclusions,<sup>1</sup> an entity's business model will normally indicate when a derecognition or a performance obligation approach would be appropriate. We believe this notion should be used as a principle for determining when each approach should be used, as we see no conceptual grounds for doing so based on the retention of risk and rewards by the lessor;
- b) Having in mind our comment above, we strongly recommend that intercompany lessors should be exempted from applying the derecognition approach to account for intercompany leases. We make this recommendation based on the following: (1) entities within the same group normally make use of other means to provide intercompany financing; (2) intercompany lessors are generally not exposed to credit risk, but to assets risks; (3) the adoption of this recommendation would considerably simplify consolidation procedures; and (4) information about intercompany leases presented in separated financial statements should not be regarded as being relevant, specially when consolidated financial statements are also provided; and
- c) For lessors applying the derecognition approach we believe that the proposed ratio for determining the amount derecognized and the initial carrying amount of the residual asset should not be based on relative fair value. The lessor would have to measure the fair value of the rights given up and the rights retained just to determine the allocation between comprehensive income and residual asset. Instead, another measure already required within the model could be used, reducing application costs.<sup>2</sup>

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<sup>1</sup> ED/2010/9.BC27.

<sup>2</sup> For example: expected cash flows, useful lives and contract terms, etc.



### Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

- a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).
- b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

### Comments on Question 3

We do not agree with the proposed simplified requirements for short-term leases as they have two distinct approaches for lessees and lessors. Instead, we believe lessees should also be allowed to elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease. This could be compensated with specific disclosures of total expenses incurred during the year with such contracts.

Nevertheless, short-term exemptions will not be enough to reduce the level of complexity associated to many of the proposed requirements (mainly those related to identification and measurement of lease assets and liabilities). Therefore we would also recommend the Board to consider the possibility of including materiality thresholds in the final version of the IFRS, so that entities participating in many small contracts may avoid some of the costs of adopting the right-of-use model.

### Definition of a lease

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#### Question 4

- a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why? (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
- b) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?



#### Comments on Question 4

In addition to our commentaries related to the question 1, we would like to mention that such definition is different from what a lease contract is legally known to be in Brazil, where it has a more restricted meaning (which also retains the concepts of operating and finance leases). This distinction usually produces misunderstandings regarding the information presented in the financial statements and difficulties in the communication between accounting-related personnel and others.

Therefore, we would like to request the Board to consider the possibility of adopting broader terminologies such as “right-of-use contracts”, “users” and “grantors” instead of lease contracts, lessees and lessors, respectively. Although this suggestion may seem to be trivial, it would reduce the complexity the adoption of the right-of-use model in Brazil and if the Board rejects it we would appreciate if some consideration could be included in the Basis for Conclusions of the proposed IFRS.

Regarding the distinction between lease contracts and contracts that represent sales and purchases, please see our comments on question 7. As for leases with service components, please see our comments on question 6.

#### Scope

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##### Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

##### Comments on Question 5

We generally agree with the proposal to retain the scope exclusions of IAS 17. However, we do have following concerns:

- a) Leases of intangible assets: the Board proposed that leases of intangible assets should not be included in the scope of the proposed IFRS and that the accounting for intangible assets would have to be considered more broadly.<sup>3</sup> However, in its Exposure Draft titled “Revenue from Contracts with Customers”, the Board addresses licenses and rights to use intellectual property owned by entities similar to lessors. We believe this approach should have been mentioned in the leases’ Exposure Draft and its expected implications for the future;
- b) Leases with service components: please see our comments on question 6; and
- c) Sales and purchases: please see our comments on question 7.

As for the scope exclusion related to leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, we believe that some additional clarification is necessary. The wording used in the exposure draft does not make clear whether the Board’s intention

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<sup>3</sup> ED/2010/9.BC36



was to exclude from the proposed scope: (1) only the rights to explore an area; or (2) the rights to explore an area and lease arrangements of assets used to explore for reserves.

Under current US GAAP requirements, the accounting for leases would not apply to agreements concerning the rights to explore for or to exploit natural resources.<sup>4</sup> If the Board's intention was to propose this view, then we would like to point out the following issues:

- a) Recognizing right-of-use assets would have no impact in an entity's earnings during the exploration and development phases, except for lease arrangements that simultaneously serve on productive fields. Generally in the oil and gas industry expenditures incurred during exploration and/or development phase are capitalized
- a) The proposed model is changing the current oil and gas accounting practice by the following reasons:
  - I. In the exploratory phase, expenditures are currently capitalized only when incurred. The ED changes the timing of asset recognition.
  - II. Dry holes costs are currently expensed when incurred. The ED may result in the recognition of the related costs as an asset in the beginning of the lease arrangement. At that moment is not probable that the entire asset will generate future economic benefits.
- b) Testing right-of-use assets for impairment may be problematic because the recoverability of exploratory costs may not be estimated until reserves are proven. Exploratory leased assets may also serve activities conducted in different areas. Additionally, in the oil and gas industry, the development phase is a complementary phase of the exploratory activity; and
- c) Internally, allocation of lease expenses by project may become less accurate. Currently, each project (well) can be directly charged as the leased assets are used. With the right-of-use model, the application of ratios for such allocation may become necessary.

Therefore, we would like to recommend the Board to consider the possibility of adopting a scope exclusion that takes into account the rights to explore for or to exploit oil and gas reserves and lease arrangements of assets (PP&E) used to explore for and develop oil and gas reserves.

#### **Question 6: Contracts that contain service components and lease components**

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

- a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- b) the IASB proposes that:

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<sup>4</sup> ASC 840-10-15 (paragraph 15).  
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- (i) a lessee should apply the lease accounting requirements to the combined contract.
- (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
- (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

#### **Comments on Question 6**

We agree with the proposed treatment for contracts that contain service components and lease components. In the case of non-distinct services included in lease contracts held by lessors applying the derecognition method, we support the FASB's proposal because we believe it results in a more principles-based approach.

We also believe that additional guidance should be provided in order to help lessees and lessors evaluate when services would have a distinct profit margin; in special, when would the service be subject to distinct risks. We believe this is important because it is still unclear for us how could an entity sell a service separately when no market exists for it.<sup>5</sup> Explaining the intentions associated to the condition would also facilitate its application.

#### **Question 7: Purchase options**

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

#### **Comments on Question 7**

We agree with the treatment proposed by the Board for the accounting of options to purchase underlying assets. However, it is unclear for us why transactions in which there is a transfer of control and all but a trivial amount of the risks and benefits associated with the underlying asset at the end of the lease term, do not meet the proposed definition of a lease.<sup>6</sup> In our view, setting a different accounting treatment for these transactions would have the following implications:

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<sup>5</sup> If such market existed, the entity would have complied with the condition presented in paragraph B7a of the Exposure Draft.

<sup>6</sup> ED/2010/9.BC59.



- a) While some purchase options would not be accounted for before being exercised, others would if they indicate the existence of control over an asset; and
- b) It increases the amount of complexity in the accounting for right-of-use transactions. Actually, by removing the abovementioned transactions from its scope, the exposure draft goes beyond what was initially expected from the right-of-use model.

For these reasons, we recommend the Board to maintain such transactions within the scope of the proposed IFRS, during the period in which full transfer of control and risks and rewards does not takes place. Once it occurs, the transaction should become subject to other applicable IFRSs.

## Measurement

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### Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

### Comments on Question 8

We fully disagree with the proposal. This approach will increase the complexity associated to the accounting for lease arrangements.

In our opinion the option to renewal should be considered only when is certain, in accordance with the management view, at the inception of the contract.

### Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

### Comments on Question 9

- 1) Measurement technique:

We fully disagree with the proposal that an expected outcome technique should be used to measure assets and liabilities arising from lease arrangements. Although we understand the concepts behind such treatment, we consider it to be excessively onerous. We recommend the adoption of an approach based on most likely outcomes, which we believe to be less complex to apply and still capable of providing useful information, specially when combined with appropriate disclosures about future cash flow uncertainties and taking into account the fact that the amounts recognized in the statement of financial position would be remeasured



whenever changes in facts or circumstances indicate that they have changed significantly since the last reporting period.

If the Board decides to require the use of the expected outcome technique, we would like to recommend the inclusion of enhanced guidance on this matter, especially regarding the determination of probabilities for each outcome. The instructions presented in the Exposure Draft are considerably simple, even when compared to similar proposed guidance included in other recent exposure documents. In fact, we believe that explaining the technique in every single standard under which the Board plans to require it, is not best approach – the guidance should be contained by one single document from which different standards could cross-reference.

2) Contingent rentals:

Regarding contingent rentals, we also fully disagree with the distinction of treatments proposed for lessees and lessors. The first one would apparently be required to estimate contingent rentals, even when such measurement could not be done reliably. The second one would estimate contingent rentals receivable only if it could be reliably measured. Besides being unreasonable, we believe this proposal could create some practical issues when it comes to eliminating intercompany transactions between investors and associates. Therefore, we would like to request an equal treatment that requires lessees to estimate contingent rentals only if it can be reliably measured.

In terms of concepts, we agree with Mr. Coopers's concerns over contingent rentals that vary according to asset usage or performance.<sup>7</sup> Even though one may argue that the inclusion of such rentals is a matter of measurement, others may argue that an obligation was not originated. For instance, during periods of lower cash inflows an entity may adjust its operations to avoid incurring in additional obligations (and not reducing current obligations). The approach proposed by the Board seems to be mostly based on the single asset approach for rights-of-use<sup>8</sup> and increases measurement complexities, especially when it comes to determine the timing of cash flows.

Still regarding contingent rentals, we believe the proposed IFRS should explain how changes in exchange rates of foreign currencies should be dealt with: (1) according to IAS 21; or (2) as contingent rentals. In our view, it would be preferable if exchange rates of foreign currencies were treated as contingent rentals accounted for adjusting the right-of-use balance whenever remeasurements take place (please see also our comment on question 10). Our reasons for making this recommendation include:

- a) the fact that foreign currency risks are not different from other uncertainties associated to lease contracts;
- b) the fact that the obligation is directly associated to the right-of-use asset, suggesting that expense recognition based on the asset's consumption pattern would be more appropriate;
- c) the fact that leased assets may generate cash inflows in currencies other than an entity's functional currency;

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<sup>7</sup> ED/2010/9.AV5.

<sup>8</sup> DP/2009/1.6.8.



- d) the fact that, based on the Board's proposals, a great level of uncertainty will be embedded in the liability's balance, which may not be paid in a fixed or determinable number of units of currency;<sup>9</sup> and
- e) the fact that the evaluation of an entity's performance might be worsened due to net income's volatility caused by changes in exchange rates.

#### **Question 10: Reassessment**

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

#### **Comments on Question 10**

As noticed in our comment on question 9, we agree with the proposal that lessees and lessors should remeasured lease assets and liabilities when facts and circumstances indicate that there is a significant change in such balances since the previous reporting period.

However, we disagree with the proposed method for recognition of changes in the expected amounts of contingent rentals and other expected payments. We believe this method will be considerably complex to apply and inconsistent with existing requirements for relatively similar estimates (IFRIC 1). In fact, applying IFRIC 1 already demands a lot of resources, despite the reduced number of items to be controlled when compared to lease arrangements.

Therefore, as an alternative approach for lessees, we would like to recommend that all changes in contingent rentals and other expected payments should be recognized as an adjustment to the right-of-use asset. In our view, only those considered to be amortization adjustments, calculated since the last date of revision, should be expensed.

#### **Sale and leaseback**

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#### **Question 11**

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

#### **Comments on Question 11**

Please see our comments on question 7, regarding the distinction between leases and purchases or sales.

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<sup>9</sup> The FASB Report, Technical Plan—April 1, 2007 through September 30, 2007, Asset Retirement Obligations to Be Settled in a Foreign Currency.

[http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage&cid=1218220178838](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1218220178838)

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## Transition

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### Question 16

- a) The exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186– BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

### Comments on Question 16

We agree that a simplified approach to transition is necessary in order to avoid prohibitive implementation costs.

### Other comments

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### Question 18

Do you have any other comments on the proposals?

### Comments on Question 18

We would like to comment on the three additional issues related to the proposals.

- 1) Discount rates:

The Board proposes that lessees should measure “the liability to make lease payments at the present value of the lease payments, discounted using the lessee’s incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee”.<sup>10</sup> In this context, the proposed definition for the incremental borrowing rate remains essentially unchanged from the current version of IAS 17.<sup>11</sup>

“The rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset.”

In our opinion, the incremental borrowing rate could be considered an appropriate discount rate for measurement of finance leases currently being account for under IAS 17. This is because the lessee is interested in substantially all the benefits that can be obtained from the leased asset.

However, we did not see the applicability of such rate when it comes to discounting arrangements currently classified as operating leases. The lessee would not be interest in

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<sup>10</sup> ED/2010/9.12a.

<sup>11</sup> ED/2010/9.Appendix A.



purchasing the asset and the rate of interest payable to finance such transaction could be considerably higher than the rate the lessor charges the lessee. In an operating lease, for instance, the lessor might be willing to accept lower rates of return as a consequence of reduced exposure to risks in general.

We believe that for most entities the incremental borrowing rate would be more appropriately defined as the rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow the funds necessary to settle its lease obligations.

However even the abovementioned definition would not be adequate for entities that: (a) participate in several lease contracts, of different magnitudes; and (b) borrow funds generally to finance its operating and capital expenditures. Entities with such profile would incur in significant costs estimating discount rates on a lease-by-lease basis and the resulting liabilities would not reflect indebtedness effectively.

Therefore, we strongly recommend the Board to review its definition for the incremental borrowing rate and to provide a lessee with the alternative of applying either individual or general discount rates, based on its debt profile.

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