



Project	Leases
Topic	Initial Direct Costs

Objective

1. The objective of this paper is to propose a converged definition of *initial direct costs* for the proposed new leases guidance.
2. The staff recommends defining initial direct costs for lessors and lessees in the proposed new leases requirements as follows:

Initial direct costs are incremental costs directly attributable to negotiating and arranging a lease.

3. This paper is structured as follows:
 - (a) Current Leases Literature
 - (b) Other Ongoing Projects
 - (c) Staff Analysis
 - (d) Staff Recommendation.

Current Leases Literature

IFRS

4. Under the guidance in IAS 17, *Leases*, initial direct costs are defined as:

Incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

IASB/FASB Staff paper

5. For lessees, IAS 17 states that initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are added to the amount recognized as an asset.
6. For lessors, IAS 17 states that initial direct costs are often incurred and include amounts such as commissions, legal fees, and internal costs that are incremental and directly attributable to negotiating and arranging a lease. Those costs exclude general overheads such as those incurred by a sales and marketing team.
7. Additionally, costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, those costs are excluded from the net investment in the lease and are recognized as an expense when the selling profit is recognized, which is normally at the commencement of the lease term for a finance lease.

U.S. GAAP

8. Under the guidance in Topic 840, *Leases*, of the *FASB Accounting Standards Codification*TM, initial direct costs include only those costs incurred by the lessor that are:
 - (a) Costs to originate a lease incurred in transactions with independent third parties that:
 - (i) Result directly from and are essential to acquire that lease.
 - (ii) Would not have been incurred had that leasing transaction not occurred.
 - (b) Directly related to only the following activities performed by the lessor for that lease:
 - (i) Evaluating the prospective lessee's financial condition
 - (ii) Evaluation and recording guarantees, collateral, and other security arrangements
 - (iii) Negotiating lease terms
 - (iv) Preparing and processing lease documents

- (v) Closing the transaction.
9. The guidance in Topic 840 further clarifies the costs directly related to those activities performed by the lessor shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for the lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs should not include costs related to any of the following activities performed by the lessor:
- (a) Advertising
 - (b) Soliciting potential leases
 - (c) Servicing existing leases
 - (d) Other ancillary activities related to establishing and monitoring credit policies, supervision, and administration.
10. Furthermore, paragraph 840-20-25-19 states that costs that should not be considered initial direct costs include items such as administrative costs, rent, and depreciation.

Other Ongoing Projects

Insurance Contracts: Acquisition Costs

11. IFRS 4, *Insurance Contracts*, does not address the accounting for acquisition costs.
12. The Master Glossary of the Accounting Standards Codification defines acquisition costs as follows:
- Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts.
13. Under the guidance in Topic 944, *Financial Services—Insurance*, of the Accounting Standards Codification, paragraph 944-30-55-1, states that all of the following costs vary with and are primarily related to insurance contracts issued

or renewed during the period in which the costs are incurred and shall be considered acquisition costs:

- (a) Agent and broker commissions
- (b) Salaries of certain employees involved in the underwriting and policy issue functions
- (c) Medical and inspection fees.

Revenue Recognition: Contract Costs

14. Contract costs are not defined in the revenue recognition project. However, in the teams' discussions of the subsequent measurement of performance obligations, onerous tests costs are considered direct costs, which are defined as follows:

Onerous costs are the direct costs (that is, all costs that relate directly to the specific contract or that were incurred only because the entity entered into the contract).

Staff Analysis

Lessee

15. In November 2009, the boards tentatively decided that initial direct costs for lessees should be added to the amount recognized in the lessee's right-of-use asset for the following reasons:
- (a) This decision is consistent with the treatment of similar costs associated with acquiring other non-financial assets (for example, property, plant and equipment or intangible assets). Thus this decision, will create comparability with other non-financial assets.
 - (b) This decision is consistent with the proposed amortized cost-based approach to the measurement of the lessee's right-of-use asset.
 - (c) Different treatment between leased assets and owned assets may provide structuring opportunities.

16. Therefore, the definition of initial direct costs should consider the current guidance for acquiring a non-financial asset because the lessee has acquired a right-of-use asset (an intangible asset).
17. Paragraph 28 of IAS 38, *Intangible Assets*, states that the cost of a separately acquired intangible asset comprises:
 - (a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
 - (b) Any directly attributable cost of preparing the asset for its intended use.
18. Furthermore, examples of directly attributable costs are:
 - (a) Costs of employee benefits (as defined in IAS 19, *Employee Benefits*) arising directly from bringing the asset to its working condition;
 - (b) Professional fees arising directly from bringing the asset to its working condition; and
 - (c) Costs of testing whether the asset is functioning properly.
19. In addition, IAS 16, *Property, Plant and Equipment*, states that the cost of an item of property, plant and equipment comprises the following:
 - a. its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
 - b. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
 - c. the initial estimate of costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.
20. IAS 16 also states that examples of directly attributable costs are:
 - (a) Costs of employee benefits (as defined in IAS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

- (b) Costs of site preparation;
 - (c) Initial delivery and handling costs;
 - (d) Installation and assembly costs;
 - (e) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
 - (f) Professional fees.
21. U.S. GAAP in Topic 350, *Intangibles – Goodwill and Other*, does not provide a definition of initial direct costs of intangible assets. In practice, one would apply the guidance in Topic 360, *Property, Plant, and Equipment*, because it is the closest applicable guidance.
22. Paragraph 360-10-30-1 states the following:
- Paragraph 835-20-05-1 states that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. As indicated in that paragraph, if an asset requires a period of time in which to carry out activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.
23. Furthermore, the Master Glossary of the Accounting Standards Codification defines activities necessary to bring an asset to the condition and location necessary for its intended use as follows:
- The term activities is to be construed broadly. It encompasses physical construction of the asset. In addition, it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities. It also includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation.

Lessor

24. In November 2009, the boards tentatively decided that initial direct costs for lessors should be added to the amount recognized in the lessor's lease receivable for the following reasons:
- (a) This decision views initial direct costs as costs that are incurred upon the lessee's request for credit (entering into the lease arrangement). Therefore, those costs are for the benefit of the lessor and relate directly to originating the loan (lease receivable).
 - (b) This decision is consistent with the treatment of costs associated with other financial assets.
25. Therefore, the definition of initial direct costs should look to the existing guidance for originating a loan and acquiring a financial asset (the lease receivable).
26. Current guidance under IAS 39, *Financial Instruments: Recognition and Measurement*, defines transaction costs in paragraph 9 as follows:
- ...incremental costs that are directly attributable to the acquisition, issue, or disposal of a financial asset or financial liability...An incremental cost is one that would not have been incurred if the entity had not acquired, issued, or disposed of the financial instrument.
27. In addition, paragraph 43 of IAS 39 states the following:
- When a financial asset or financial liability is recognized initially, an entity shall measure it as its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.
28. Additionally, measurement guidance in paragraph 310-20-25-3, *Receivables*, states that the definition of direct loan origination costs are applicable to lessors in determining the net amount of initial direct costs:
- All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those

activities, unsuccessful loan origination efforts, and **idle time** shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

29. The Master Glossary of the Accounting Standards Codification defines direct loan origination costs as follows:

Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:

- a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
- b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
 1. Evaluating the prospective borrower's financial condition
 2. Evaluating and recording guarantees, collateral, and other security arrangements
 3. Negotiating loan terms
 4. Preparing and processing loan documents
 5. Closing the transaction.

The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. (See Section 310-20-55 for examples of items.)

Additional Analysis

30. The staff thinks that there are two components of the current definitions of initial direct costs that should be brought forward into the proposed new leases guidance: *incremental* and *directly related to negotiating the lease*.
31. Unlike IFRSs, the U.S. GAAP definition of initial direct costs does not explicitly refer to *incremental costs*. However, the U.S. GAAP definition of initial direct costs does implicitly include the notion of incremental costs.

32. The Master Glossary of the Accounting Standards Codification defines incremental direct costs as follows:

Incremental direct costs to sell an asset or transfer a liability refer to those costs that meet both of the following criteria: (a) they result from and are essential to that transaction and (b) they **would not have been incurred** by the reporting entity had the decision to sell the asset or transfer the liability not been made. [emphasis added]

Costs to originate a loan that have both of the following characteristics: (a) result directly from and are essential to the lending transaction and (b) **would not have been incurred** by the lender had that lending transaction not occurred. [emphasis added]

33. The phrase *would not have been incurred* is included in the definitions of incremental costs under U.S. GAAP. That phrase is also included in the current definition of initial direct costs in paragraphs 840-20-25-17 through 20.
34. Although the FASB's current definition of initial direct costs does not explicitly state that the costs must be incremental, the staff note that it is implicitly stated. Therefore, the staff recommends that the definition of initial direct costs explicitly include the notion of the costs being incremental.
35. Both the IASB and FASB current definitions seem to indicate that initial direct costs must be *directly attributable* to negotiating the lease. However, both definitions use different wording to illustrate this.
36. The IFRS definition states that initial direct costs are costs that are *directly attributable to negotiating and arranging a lease*.
37. FASB's definition states that initial direct costs are the costs to originate a lease and have the following characteristics:
- (a) The costs result directly from and are essential to acquire that lease.
 - (b) The costs would not have been incurred had that leasing transaction not occurred.
38. As both definitions indicate that these costs must be directly related to the lease, the staff recommend including that in the definition of initial direct costs. In addition, it is those costs necessary to negotiate and arrange the lease.

Staff Recommendation

39. The staff recommends developing a converged definition of initial direct costs in the proposed new leases requirements. Based on the analysis above, the staff recommends the following definition of initial direct costs:

Initial direct costs are incremental costs directly attributable to negotiating and arranging a lease.

40. The staff notes that the proposed definition is not intended to change current practice.
41. Additionally, the staff recommends including additional guidance in the proposed new leases requirements to further illustrate which costs could be considered initial direct costs assuming that they are (a) incremental costs and that they are (b) directly attributable to negotiating and arranging a lease. That additional guidance would be similar to the examples included in the current leases literature as follows:

- (a) Commissions
- (b) Legal fees
- (c) Evaluation and recording guarantees, collateral, and other security arrangements
- (d) Negotiating lease terms
- (e) Preparing and processing lease documents
- (f) Closing the transaction
- (g) Internal costs that are incremental and directly attributable to negotiating and arranging the lease.

42. That additional guidance could also include examples that would not meet the definition of initial direct costs. For example:

- (a) General overheads
- (b) Advertising
- (c) Soliciting potential leases
- (d) Servicing existing leases
- (e) Other ancillary activities.

Question 1

Question 1 – The staff recommends defining initial direct costs as incremental costs directly attributable to negotiating and arranging a lease. Do the boards agree? If not, why not?

Question 2

Question 2 – The staff recommends including additional guidance in the proposed new leases requirements to further illustrate which costs are directly attributable to acquiring a lease. Do the boards agree with this guidance? If not, why not?