IASB/FASB Meeting
Week commencing 21 March 2011

IASB Agenda reference 11A

FASB Agenda reference 145

Staff Paper

Project	**Leases**
Topic	**Initial Direct Costs**

Objective

1. The objective of this paper is to discuss:
   (a) the definition of *initial direct costs*
   (b) the accounting by lessees and lessors for initial direct costs.
2. The staff recommends that *initial direct costs* should be defined as:

   > Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.
3. The staff also recommends that lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.
4. The staff has analyzed how a lessee and a lessor should allocate any initial direct costs that are capitalized as part of the right-of-use asset and the right to receive lease payments respectively between the multiple elements of a contract that contains a lease. That issue will be discussed in a future paper.
5. This paper is organized as follows:
   (a) Summary of the proposals in the *Leases* Exposure Draft (ED)
   (b) Summary of feedback
   (c) Staff analysis and recommendations
      (i) Definition of initial directs costs

(ii) The accounting for initial direct costs

(d) Appendix A: current guidance and ongoing projects

(e) Appendix B: proposed wording.

Summary of Proposals in the ED

6. The ED proposes that lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively. The ED defines *initial direct costs* as:

> Recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

7. Additionally, the ED includes application guidance as follows:

> Initial direct costs result directly from, and are essential to, acquiring or originating a lease and would not have been incurred had the lease transaction not been made. They may include:
>
> (a) commissions
>
> (b) legal fees
>
> (c) evaluation of the prospective lessee's financial condition
>
> (d) evaluating and recording guarantees, collateral and other security arrangements
>
> (e) negotiating lease terms
>
> (f) preparing and processing lease documents
>
> (g) closing the transaction
>
> (h) other costs that are incremental and directly attributable to negotiating and arranging a lease.
>
> The following items are not initial direct costs:
>
> (a) general overheads, such as rent, depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time
>
> (b) costs related to activities performed by the lessor for advertising, soliciting potential leases, servicing existing leases or other ancillary activities.

Summary of Feedback

8. The Boards did not ask a specific question about initial direct costs in the ED. Therefore, there were very few respondents that commented on the issue.

9. Those respondents that made comments about initial direct costs (about 5 percent of all respondents) were mostly concerned about consistent treatment of initial direct costs across multiple ongoing projects, such as insurance contracts and revenue recognition.

> We strongly recommend consistent accounting treatment of costs related to all forms of contracts including leases, revenue from non-lease contracts, insurance contracts and executory contracts (CL #780).

10. Some respondents commented on lease incentives and asked for clarification on whether lease incentives should be accounted for in a manner that is similar to initial direct costs. The staff will address lease incentives in a future paper.

Private Company Feedback

11. Private company respondents expressed the same general concerns as public company constituents. One respondent recommended that the guidance for initial direct costs be consistent under leases and revenue recognition. Another respondent agreed with the proposal in the ED to capitalize and amortize initial direct costs.

Staff Analysis

Definition of Initial Direct Costs

12. The ED defines initial direct costs as recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

13. Please see Appendix A for the definition of acquisition costs under the following current projects: insurance contracts, revenue recognition, and financial instruments.

14. Very little feedback about the definition of initial direct costs was received. The staff thinks that the definition in the ED is appropriate and consistent with

current lease guidance under Topic 840 and IAS 17. The staff notes that the proposed definition is not intended to change current practice for how initial direct costs are defined (see Appendix A for current guidance). Therefore, the staff recommends that the Boards confirm the definition in the ED with one clarification.

15. The staff notes that the term *recoverable* was not in the initial Board decision, but was added to the definition during the drafting of the ED. The staff thinks that the notion of recoverability is implicit in the definition and, thus, is redundant. The term *recoverable* is implied in the definition because neither a lessor nor a lessee would incur costs to obtain a lease contract if they did not think they would be able to recover those costs. One respondent suggested that the Boards remove the term *recoverable* from the definition because it is superfluous and unnecessary.

16. The staff recommends that the Boards remove the notion of ‘recoverable’ because it is implicit in the definition of initial direct costs. Accordingly, the definition should read as follows:

> Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

Question 1

The staff recommends that the Boards confirm the definition of initial direct costs in the ED, with the exception of removing the term *recoverable*.

Do the Boards agree? Why or why not?

Accounting for Initial Direct Costs – Lessee

17. The staff first considered whether initial direct costs incurred by lessees should be allocated between the asset and liability arising from a lease. Although that approach is conceptually sound, the staff thinks that such an approach would be costly to apply with little benefit for users of financial statements and would add complexity to the leases standard.

18. Therefore, the staff considered the following two approaches:

(a) Approach 1: capitalize initial direct costs for lessees and recognize the amount in the lessee’s right-of-use asset (confirm the decision in the ED)

(b) Approach 2: expense initial direct costs as incurred.

Approach 1: Capitalize initial direct costs of the lessee

19. The staff identified the following advantages to Approach 1:

    (a) It is consistent with the treatment of similar costs associated with acquiring other nonfinancial assets (for example, property, plant, and equipment and intangibles). Thus, this approach would create comparability with the measurement of other nonfinancial assets.

    (b) It is consistent with the proposed amortized cost-based approach to the measurement of the lessee’s right-of-use asset. In general, cost includes incremental costs directly attributable to the acquisition of the asset.

    (c) Different treatment between leased assets and owned assets may provide structuring opportunities.

20. The staff thinks that there are similarities between the right-of-use asset and the underlying asset. The lessee uses the right-of-use asset (for example, a leased motor vehicle) the same way that it uses an owned asset (for example, an owned motor vehicle) in its normal course of business. The lessee’s rights conveyed in a lease contract are similar to the rights obtained from owning the underlying asset for less than its useful life. Therefore, capitalizing the costs avoids the need to justify why different treatments are necessary between leased assets and owned assets.

21. Also, Approach 1 is consistent with the treatment of initial direct costs for lessees in a finance lease under IAS 17 (Topic 840 is silent on the treatment of initial direct costs in a capital lease for a lessee), because any initial direct costs of the lessee are added to the amount recognized as an asset.

22. There is a concern that if the lessee capitalizes the initial direct costs in the right-of-use asset, it would increase the asset value and the risk that the right-of-use asset is impaired. The staff does not see this as a significant issue

because it thinks that a lessee would consider the implications of the initial direct costs when determining whether it is economical to enter into a lease contract. That issue, including whether initial measurement of the right-of-use asset should be capped at the fair value of the right-of-use asset, also will be further discussed when the staff addresses impairment in a separate paper.

Approach 2: Expense initial direct costs as incurred

23. Approach 2 is consistent with the accounting for transaction costs arising in business combinations. Topic 805 and IFRS 3 both require all acquisition-related costs in a business combination to be expensed as incurred.

24. It can be argued that initial direct costs are not part of the exchange between the lessor and the lessee; rather, the costs arise from separate transactions in which the lessee pays for services received. The benefits obtained from incurring those costs are consumed as the services are received.

25. Although this approach would be less costly and simpler to apply than Approach 1, it is inconsistent with an amortized-cost based approach to initial measurement of a right-of-use asset.

Staff recommendation

26. The staff recommends Approach 1; that is, initial direct costs should be added to the amount recognized in the lessee's right-to-use asset because:

    (a) Approach 1 is consistent with the treatment of similar costs associated with acquiring other nonfinancial assets (for example, property, plant, and equipment and intangibles). Thus, that would create comparability with the measurement of other nonfinancial assets.

    (b) Approach 1 is consistent with the proposed amortized cost-based approach to the measurement of the lessee's right-of-use asset. In general, cost includes incremental costs directly attributable to the acquisition of the asset.

Question 2
The staff recommends that the Boards affirm the decision in the ED that initial direct costs should be included in the amount recognized for the lessee's right-of-use asset. Do the Boards agree? Why or why not?

Accounting for Initial Direct Costs – Lessor

27. The staff considered the following two approaches for the treatment of initial direct costs for lessors:

    (a) Approach 1: capitalize initial direct costs and recognize the amount in the lessor's lease receivable (confirm the decision in the ED)

    (b) Approach 2: expense initial direct costs as incurred.

Approach 1: Capitalize initial direct costs and recognize the amount in the lessor's lease receivable

28. Those respondents that commented on the treatment of initial direct costs recommended consistent accounting treatment of the costs of obtaining a contract in the ongoing projects (for example, insurance contracts and revenue recognition).

29. Approach 1 is generally consistent with the recent decision made in the revenue recognition project in which the decision in the revenue recognition ED was overturned to improve consistency with other projects (that is, insurance contracts and financial instruments). That decision also improves consistency within current guidance for transaction costs under IFRS 9 and the costs of securing a right to provide management services in IAS 18. In the revenue recognition project, the Boards tentatively decided that an entity should recognize an asset for incremental costs of obtaining a contract that an entity expects to recover. Incremental costs of obtaining a contract are costs than an entity would not have incurred if the contract had not been obtained.

30. Approach 1 also is generally consistent with the recent decision made in the insurance contracts project in which the Boards tentatively decided that at initial recognition, an insurer would include incremental acquisition costs that

relate to a portfolio of insurance contracts in the present value of fulfillment cash flows.

31. In Approach 1, initial direct costs are viewed as costs that are initiated upon the negotiation of the lease arrangement and directly related to the lessor's lease receivable. The staff has identified the following advantages to Approach 1:

    (a) It is consistent with the treatment of costs associated with some financial assets; consequently, it increases comparability between financial assets.

    (b) It is consistent with the staff recommendation in question 1 to capitalize initial direct costs for lessees.

32. One respondent raised a concern about the effect of capitalizing initial direct costs on the lessor's recognition of interest income.

> The right to receive lease payments is subsequently measured at amortized cost using the effective interest method. As such, it would appear that the capitalization of initial direct costs by the lessor would affect the recognition of interest income over the term of the lease. That is, a lessor would need to impute an effective interest rate (other than the rate the lessor charges the lessee) to allocate the payments received between interest income and a reduction in the right to receive lease payments (CL #74).

33. The staff notes that this point is valid. However, as mentioned in paragraph 31, this approach is consistent with the treatment of costs associated with other financial assets. In Approach 1, the initial direct costs are viewed as part of the lessor's investment in the lease. A lessor would include initial direct costs in the pricing of the contract to recover those costs. Therefore, because initial direct costs are part of the investment, the effective interest method of interest income recognition appropriately reflects the effective interest rate on that investment.

34. One respondent expressed the concern that if the lessor capitalizes the initial direct costs, it may double count those costs.

> The lessor would generally reflect the cost of initial direct costs in the pricing of the rentals and so adding the initial direct costs to the right to receive lease payments would represent a double counting (CL #122).

35. The staff does not view this as double counting, as long as the lease is discounted using the implicit rate in the lease.

Approach 2: Expense initial direct costs as incurred

36. Approach 2 is consistent with current lease guidance in IAS 17 and Topic 840 for lessors in a sales-type lease (that is, a manufacturer or dealer lessor) that requires those lessors to expense initial direct costs as incurred when selling profit is recognized.

37. The staff also notes that expensing initial direct costs may be less costly and less complex for lessors.

Staff recommendation

38. The staff recommends Approach 1; that is, initial direct costs should be added to the amount recognized in the lessor's right to receive lease payments because:

    (a) It is consistent with the treatment of costs associated with some financial assets; consequently, it increases comparability between financial assets.

    (b) It is consistent with the staff recommendation in question 1 to capitalize initial direct costs for lessees.

Question 3
The staff recommends that initial direct costs should be added to the amount recognized in the lessor's lease receivable. Do the Boards agree? Why or why not?

Appendix A: Current Guidance and Ongoing Projects

A1. This appendix summarizes the current guidance for the definition of initial direct costs under Topic 840 and IAS 17.

A2. This appendix also summarizes the guidance related to initial direct costs in the following ongoing projects:

(a) insurance contracts

(b) financial instruments

(c) revenue recognition

IFRS

A3. In IAS 17, 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.

A4. 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.

A5. 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.

A6. Additionally, costs incurred by manufacturers 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

A7. Under the guidance in Topic 840, initial directs 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) Evaluating and recording guarantees, collateral, and other security arrangements

(iii) Negotiating lease terms

(iv) Preparing and processing lease documents

(v) Closing the transaction.

A8. The guidance in Topic 840 further clarifies that 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.

A9. 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.

Insurance Contracts

A10. In the Insurance Contracts Exposure Draft *incremental acquisition costs* are defined as follows:

> The costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.

A11. In recent redeliberations in the insurance project, the FASB tentatively decided (the IASB did not come to a consensus) that the acquisition costs included in the cash flows of insurance contracts would be limited to:

(a) Those costs related to successful acquisition efforts

(b) Direct costs that are related to the acquisition of a portfolio of contracts.

A12. The IASB tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer would incur in acquiring the portfolio, including costs that relate directly to the acquisition of the portfolio, such as commissions. No distinction would be made between successful efforts and unsuccessful efforts.

Revenue Recognition

A13. The revenue recognition project defines *acquisition costs* as incremental costs of obtaining a contract that an entity expects to recover and would not have incurred if the contract had not been obtained.

Financial Instruments

A14. The IASB's Financial Instruments Exposure Draft requires deferral of all transaction costs, which are defined 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.

A15. The FASB's Financial Instruments Exposure Draft requires deferral of direct loan origination costs (net of loan origination fees), which are defined as follows:

> Direct loan origination costs represent costs associated with successfully originating a loan. Direct loan origination costs of a complete loan shall include the following:
>
> Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan.
>
> Certain costs directly related to specified activities performed by the lender for that loan.

Appendix B: proposed wording

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards reach decisions on the scope of the leases standard. The Boards have not yet made decisions about the views reflected in this appendix and, therefore, the wording is subject to change. The wording in this appendix shows marked changes from what was proposed in the Leases ED.

Defined Terms

B1. **Initial Direct Costs**: ~~Recoverable costs~~ Costs that are directly attributable to negotiating and arranging a **lease** that would not have been incurred had the least transaction not been made.

Application Guidance

B2. Initial direct costs result directly from, and are essential to, acquiring or originating a lease and would not have been incurred had the lease transaction not been made. Those costs to the lessee or the lessor may include:

(c) commissions

(d) legal fees

(e) evaluation of the prospective lessee's financial condition

(f) evaluating and recording guarantees, collateral and other security arrangements

(g) negotiating lease terms

(h) preparing and processing lease documents

(i) closing the transaction

(j) other costs that are incremental and directly attributable to negotiating and arranging a lease.

B3. The following items are not initial direct costs:

(a) general overheads, such as rent, depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time

(b) costs related to activities performed by the lessor for advertising, soliciting potential leases, servicing existing leases or other ancillary activities.