IFRS

STAFF PAPER

November 2013

IFRS Interpretations Committee Meeting

Project	**IAS 17 *Leases***		
Paper topic	Meaning of 'incremental costs'		
CONTACT(S)	Anna Heining	aheining@ifrs.org	+44 (0)20 7246 6428

Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request for clarification about IAS 17 *Leases*. The submission relates to the meaning of 'incremental costs' within the context of IAS 17.

2. The submitter asks which costs qualify as 'incremental costs'. In particular, whether salary costs of permanent staff involved in negotiating and arranging new leases as a lessor qualify as 'incremental costs'. Incremental costs are included as initial direct costs in the initial measurement of a lessor's finance lease receivable.

3. This paper will discuss the meaning of 'incremental costs' in the context of IAS 17, in particular whether internal fixed costs qualify as 'incremental costs'.

Submission received

4. The submitter describes a situation in which an entity provides finance to entities as either a lessor, a lender or both. The staff employed on this activity spend all (or substantially all) of their time negotiating and arranging new leases and/or loans. The submitter explains that "these staff are permanent employees with fixed salaries".

5. The submitter notes that the business consists of relatively high volumes of smaller transactions so that each employee deals with dozens of new contracts

each month. The submitter contends that it is the nature of the business that, as the volume of transactions increases, so will the number of employees required to process new leases. Similarly, if the entity were to stop writing new transactions, these employees would rapidly be made redundant with one month's notice. The submitter contends that the staff costs can be attributed to individual leases via a cost allocation.

6. A copy of the submission is included in Appendix A.

Paper structure

7. The paper is organised as follows:

   (a) requirements of IAS 17;

   (b) analysis: do internal fixed costs qualify as 'incremental costs'?;

   (c) outreach performed;

   (d) staff analysis;

   (e) assessment against the Interpretations agenda criteria;

   (f) staff recommendation; and

   (g) tentative agenda decision.

Requirements of IAS 17

8. Paragraph 38 of IAS 17 requires that, for finance leases, the lessor includes initial direct costs in the initial measurement of the finance lease receivable.

9. Paragraph 4 of IAS 17 defines initial direct costs as "incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors".

10. Paragraph 38 of IAS 17 further states:

> 38 Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those

> incurred by a sales and marketing team. For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the finance lease receivable; there is no need to add them separately. 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, they are excluded from the net investment in the lease and are recognised as an expense when the selling profit is recognised, which for a finance lease is normally at the commencement of the lease term.

Do internal fixed costs qualify as 'incremental costs'?

11. The submitter refers to conflicting advice given by different accounting firms, a national accounting institute and different views within the industry:

    (a) **View A:** internal fixed costs (such as the staff costs set out above) do *not* qualify as 'incremental costs' and therefore should *not* be included as initial direct costs in the lessor's lease receivable.

    (b) **View B**: internal fixed costs (such as the staff costs set out above) do qualify as 'incremental costs' and therefore should be included as initial direct costs in the lessor's lease receivable.

View A—internal fixed costs do not qualify as incremental costs

12. Supporters of View A think that internal fixed costs do not qualify as incremental costs because:

    (a) the staff costs do not vary depending on whether the entity negotiates and arranges a lease; and

    (b) the definition of initial direct costs in IAS 17 refers to "incremental costs that are directly attributable to negotiating and arranging **a** lease" [emphasis added]—ie not to negotiating and arranging leases. Consequently, only costs that vary on an individual lease level should qualify as incremental costs.

View B—fixed costs do qualify as incremental costs

13. Supporters of View B think that some internal fixed costs could qualify as incremental costs, because:

    (a) the costs change in line with the scale of the business. The staff costs could be avoided in the (near) future (by making employees redundant with one month's notice period) and, therefore, there is a link between the volume of transactions (negotiating and arranging leases) and the staff costs.

    (b) The definition of initial direct costs in IAS 17 refers to incremental costs that are "**directly attributable** to negotiating and arranging a lease" [emphasis added]. Even though no additional cost is incurred due to each individual lease, the staff costs still qualify as 'incremental' as long as there is a clear and non-arbitrary method of allocating the costs to an individual lease.

Outreach performed

14. We performed outreach on this topic with national accounting standard-setters (ie the International Forum of Accounting Standard Setters (IFASS)), two securities regulator (IOSCO, ESMA) and the large international audit networks. The purpose of the request was to find out whether the issue raised by the submitter is widespread and whether significant diversity in practice exists, in particular with regard to:

    (a) the nature of costs that qualify as 'incremental costs' (ie do fixed costs qualify as 'incremental costs'?); and

    (b) the unit of account when assessing whether costs qualify as incremental costs (ie is it a single lease or could it be a portfolio?).

15. A copy of the outreach request is included in Appendix B.

16. The geographical breakdown for the responses received from the national standard-setters is as follows:

Geographical region	Number of respondents
Asia	3
Europe	4
Americas	4
Oceania	1
Africa	1
Total respondents	**13**

17. We received 18 responses to the outreach request (13 responses from national standard-setters (see geographical breakdown for the responses above), four responses from the large international audit networks and two responses from regulators). All but one of the respondents report that they do not see diversity in practice regarding the issue raised by the submitter. One jurisdiction, however, noted that although the predominant approach is to recognise fixed costs as an expense, there is diversity in practice because some companies capitalise a portion of the costs using different allocation methods between successful and unsuccessful originated leases.

18. Most respondents think that the internal fixed costs (such as the staff costs set out above) do not qualify as 'incremental costs' and should therefore not be included as initial direct costs in the initial measurement of the lessor's finance lease receivable. This is because fixed costs are unavoidable regardless of whether a lease is negotiated or arranged. Consequently, most respondents conclude that fixed costs are not 'incremental'.

19. When assessing 'incremental' in accordance with IAS 17, the majority of respondents think that costs must be directly linked to an individual lease, ie the unit of account is a single lease, *not* a portfolio of leases. However, a few respondents are of the view that costs arising on a portfolio level would be attributable to a lease via an allocation of costs.

Staff analysis

20. When analysing the meaning of ‘incremental costs’ in the context of IAS 17, we think the following question needs to be addressed:

    (a) *Nature of the costs*—what types of costs qualify as ‘incremental costs’? Do costs need to be variable or can they be fixed? Are fixed costs capable of qualifying as ‘incremental costs’ if they could be reduced in the (near) future and could, therefore, become variable?

Nature of the costs

21. Paragraph 38 of IAS 17 requires a lessor to include (in the initial measurement of the finance lease receivable) internal costs that are “incremental and directly attributable to negotiating and arranging a lease”. IAS 17 does not include a definition of ‘incremental’. However, there are other Standards that refer to the term ‘incremental’, such as IAS 39 *Financial Instruments: Recognition and Measurement* or the 2011 Exposure Draft on Revenue Recognition.

22. IAS 39 defines transaction costs as “Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.” The definition then specifies that an incremental cost is one that “‘[…] would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.”

23. We conclude from IAS 39 that ‘incremental’, with respect to initial direct costs in IAS 17, should be interpreted as costs that would not have been incurred if the entity had not negotiated and arranged a lease.

24. We conclude from the definition of ‘incremental’ by analogy with IAS 39 that only variable costs qualify as ‘incremental’. That is, incremental costs need to be caused by an event and need to change in proportion to this event (in this case, negotiating and arranging a lease).

25. The submitter argues that the staff costs set out in this paper could be considered ‘incremental’ because the costs change in line with the scale of the business (even though no additional cost is incurred due to each individual transaction). The

submitter contends that although the costs are for permanent employees with fixed salaries, employees could be rapidly made redundant (usually with one month's notice) if the volume of transactions changes. Hence, the costs could be avoided in the (near) future and therefore, could become variable.

26. We disagree with the submitter's assessment. Fixed costs (such as those set out in this paper) are unavoidable and would have been incurred without negotiating and arranging a lease. That is, the costs have not been caused by negotiating and arranging a lease; they are incurred in any event. Consequently, we think that the staff costs are not 'incremental'.

27. The outreach performed on this issue has shown that the predominant practice is to expense fixed costs. This approach is consistent with our reading of the Standard. In conclusion, we think fixed costs (such as the fixed salary costs of permanent employees) are not incremental and should therefore not be included as initial direct costs in the initial measurement of the lessor's finance lease receivable. This is because fixed costs are independent of the current level of activity, ie they are incurred regardless of whether an entity negotiates and arranges a lease.

Single lease versus group of leases

28. In the submission there was some concern expressed about whether the analysis of what represents an 'incremental cost' should be based on costs associated with an individual lease or multiple leases. Our analysis, as set out in paragraphs 21–27, discusses whether costs are 'incremental' and is independent of whether costs relate to a single lease or multiple leases. We think that the conclusions that we have drawn are also applicable when looking at a group of leases.

Assessment against the Interpretations agenda criteria

30. The staff's assessment of the agenda criteria[1] is as follows:

Agenda criteria

We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	Any guidance provided by the Interpretations Committee could have a widespread or material effect on almost every lessor.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	The outreach performed indicated that there is no diversity in practice.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	The requirements in IAS 17 for the accounting of initial direct costs are sufficient.
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (5.17)?	The requirements in IAS 17 for the accounting of initial direct costs are sufficient.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified)...	We note that the IASB is currently undertaking a project on leases. Because IAS 17 will be replaced by the IASB's final Standard on leases, it might not be efficient to provide an Interpretation of a Standard that will be superseded.

Staff recommendation

31. On the basis of our assessment of the Interpretations Committee's agenda criteria, and also on our analysis in this paper, we recommend that the Interpretations Committee should not take the issue analysed onto its agenda.

[1] These criteria can be found in the *IFRS Foundation Due Process Handbook* as indicated in the paragraphs below.

Questions to the Interpretations Committee

1. Do you agree with the staff recommendation not to add this topic to the Interpretation Committee's agenda?
2. Do you agree with the wording of the tentative agenda decision?

Tentative agenda decision

32. We propose the following wording for the agenda decision:

IAS 17 *Leases*—meaning of 'incremental costs'

The Interpretations Committee received a request for clarification about IAS 17 *Leases*. The submission relates to the meaning of 'incremental costs' within the context of IAS 17.

The submitter asks whether the salary costs of permanent staff involved in negotiating and arranging new leases (and loans) qualify as 'incremental costs' within the context of IAS 17 and should therefore be included as initial direct costs in the initial measurement of the finance lease receivable.

The Interpretations Committee noted that internal fixed costs do not qualify as 'incremental costs'. Only those costs that would not have been incurred if the entity had not negotiated and arranged a lease should be included in the initial measurement of the finance lease receivable. The Interpretations Committee also noted that there does not appear to be diversity in practice on this issue.

On the basis of the analysis above, the Interpretations Committee determined that, in the light of the existing IFRS requirements, neither an Interpretation nor an amendment to IFRSs was necessary and consequently [decided] not to add this issue to its agenda.

Appendix A
Original agenda request

33. The Interpretations Committee received a request for clarification on the application of initial direct costs as specified in IAS 17 *Leases*. The request below has been rendered anonymous with respect to the submitter.

Dear Sirs,

IAS 17-Accounting by a Lessor -IDC Definition of Incremental Costs

1. **Introduction**

We are currently in discussion with our auditors about the correct interpretation and use of the term "Incremental costs" in relation to IDC as specified in IAS17. Our companies write lease and loan business and prepare annual statements and accounts under IFRS. In previous companies using the same accounting standards we have seen a wide interpretation by other auditors of what qualifies to be treated as "Incremental", including one of the top 4 audit firms.

2. **Background**

We have some employees (on payroll - not on contract) who spend all (or substantially all) of their time on the negotiating, arranging and creation of new transactions. However, these staff are permanent employees with fixed salaries. The new business consists of relatively high volumes of smaller transactions so that each employee deals with dozens of new contracts per month. It is the nature of the business that as the volume of business increases so will the number of employees required to process new leases. Similarly, if the business were to stop writing new business these employees would be rapidly made redundant / served notice (usually one month).

It is our belief that some of these fixed costs should be capitalised as Initial Direct Costs as the costs increase/decrease in line with the scale of the new business, even though no additional cost is incurred due to each individual transaction. We do not believe the treatment of these costs should differ if the costs are incurred via payroll rather than costs via a subcontractor under contract.

3. **Technical Views**

This was discussed with the technical team of a [national accounting institute] who appeared to agree with this view as long as there is a clear and auditable method of allocating the time worked by these staff to individual transactions and proposals.

[Our auditors] do not agree with our interpretation of incremental costs. Although IAS 17 does not include a definition of 'incremental', they have used a definition in the context of transaction costs for financial instruments in IAS 39 in forming their view. This definition defines transaction costs as 'Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.'

The definition then specifies that an incremental cost is one that '…would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.'

They note that the use of the singular 'instrument' is consistent with the definition of initial direct costs in IAS 17, which refers to 'negotiating and arranging a lease' (and not negotiating and arranging leases). Consequently, their analysis of what represents an incremental direct cost for the purposes of IAS 17 is based on costs associated with each separate lease contract. Therefore, their view is that it is not appropriate to look at the overall population of lease contracts that are entered into as a single unit of account and so the staff costs set out above should not be capitalised as IDC.

4. Reasons for IFRIC to address this issue

We believe that there is currently some divergence within the industry in the interpretation and application of "incremental" in the context of IDC spreading under IAS 17. While we do not have access to detailed analysis on this point, informal conversations with finance employees of other leasing companies have led to the impression that a range of interpretations is being applied. Our discussions with different audit firms on this point over a number of years has also revealed a divergence of opinion on this policy. Therefore, it is our opinion that some additional guidance or clarification from IFRIC is necessary to provide the consistency that appears to be currently lacking.

I look forward to your response on this proposal and to hear further as the submission progresses through the IFRIC process.

Yours sincerely

Appendix B
Outreach request

34. The following email was sent out to national standard-setters, regulators, and the large international audit networks.

In June 2013, the IFRS Interpretations Committee received a request to clarify the application of the term 'incremental costs' in relation to initial direct costs as specified in IAS 17 *Leases*. A copy of the submission is attached.

Definition of the problem

The submitter has employees (on payroll – not on contract) who spend all (or substantially all) of their time on the negotiation, arranging and creation of new transactions. These staff are permanent employees with fixed salaries.

The submitter questions whether the staff costs set out above qualify as 'incremental costs' that should be capitalised as initial direct costs or whether the analogy of IAS 39 referring to a singular contract ('instrument') precludes those costs from being capitalised as those costs are incurred on a portfolio level rather than on a single lease basis.

The submitter notes that the new business consists of relatively high volumes of smaller transactions so that each employee deals with dozens of new contracts per month. It is the nature of the business that as the volume of business increases so will the number of employees required to process new leases. Similarly, if the business were to stop writing new business these employees would be rapidly made redundant / served notice (usually one month).

Current practice

The submitter refers to conflicting advice given by different accounting firms, a national accounting institute and within the industry. (This issue might not only arise in the context of initial direct costs as specified in IAS 17 but also in the context of a number of other standards.)

The possible accounting treatment will differ depending on whether:

a) fixed costs are capable of qualifying as 'incremental costs'; and
b) the analogy of IAS 39 referring to a singular contract precludes treating fixed costs incurred on a portfolio basis as initial direct costs.

The submitter contends that they could allocate the costs to individual leases.

Request for information

I would very much appreciate your observations in your jurisdiction, regarding the following aspects of the concern raised:

1. Do you see diversity in practice regarding
    a. how fixed costs (such as those set out above) are being treated in relation to initial direct costs (ie do fixed costs qualify as 'incremental costs')
    b. which costs are being capitalised as initial direct costs (ie only costs incurred on a single lease basis or also costs incurred on a portfolio level).

    If yes, please explain how. What is the prevalent approach in your jurisdiction to account for these transactions?

If you have any other information that you think would be useful in analysing this issue, or any general comments to make on this topic, please include them in your response.