

March 17, 2014

International Financial Reporting Standards  
Interpretations Committee  
30 Cannon Street  
London  
EC4M 6XH

Subject: Tentative agenda decision – IAS 17 Leases – Meaning of incremental costs

Dear IFRS Interpretations Committee members,

This letter is submitted by the Real Property Association of Canada (REALpac) in response to the tentative agenda decision from the November 2013 discussion on IAS 17 Leases, Meaning of Incremental costs.

REALpac is Canada's senior national industry association for owners and managers of investment real estate. Our Members include publicly traded real estate companies, real estate investment trusts (REITs), private companies, pension funds, banks and life insurance companies. The association is further supported by large owner/occupiers and pension fund advisers as well as individually selected investment dealers and real estate brokerages. Members of REALpac currently own in excess of \$180 Billion CAD in real estate assets located in the major centers across Canada

### **REALpac's Comments**

The Interpretations Committee received a request for clarification about IAS 17 *Leases* related to the meaning of “incremental costs” within the context of IAS 17, and in particular, whether salary costs of permanent staff involved in negotiating and arranging new leases as a lessor qualify as “incremental costs”.

We do not support the Interpretations Committee's tentative decision that internal salary costs do not qualify as incremental costs. In addition, we would assert that there is diversity in practice on this issue.

IAS 17 paragraph 38 states that “(I)nitial 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.” In Canada, we consider certain internal costs as incremental and variable costs, not fixed. These costs are directly related to specific activities performed by the lessor that would not have occurred but for that successfully executed lease. Those activities may include: evaluating a prospective lessee’s financial condition, evaluating and recording security arrangements, negotiating lease terms, preparing and processing lease documents and closing the lease transaction. These activities are initiated upon the prospective lessee’s desire to enter into a lease, on behalf of the lessor and they relate directly to entering into the successfully executed lease. Therefore, they are integral to leasing. Among other examples, these companies typically have systems in place to track the number of successful leases completed by each internal leasing staff or time spent on successful deals in order to allocate costs (and time) to a specific lease arrangement and capitalize certain internal costs that relate to successful leases. Furthermore, these companies typically make reference to market-based rates for specific leasing activities which would establish an upper limit of what could be capitalized. Companies who make the rational business decision to minimize cost through employment of internal leasing personnel, opposed to hiring external leasing brokers should not be impacted by the accounting treatment. To make the issue even worse, some companies use both internal and external leasing. This will result in inconsistent accounting within the same company, which would make evaluating the results very difficult.

By our interpretation of paragraph 38, these internal costs meet the requirements of being both incremental and directly attributable to negotiating and arranging a lease.

In the Staff Paper (Agenda ref 7) from the November 2013 IFRIC meeting, points 21 – 26, reference is made to IAS 39, whereby an incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.” While we agree that incremental costs should be interpreted as costs that would not have been incurred if the entity had not negotiated or initiated leases, we disagree with the conclusion in points 26 and 27 that salaried employees are “permanent” and that these salaries are “fixed” costs that are “unavoidable”. Particularly where companies use time-tracking systems to allocate time and costs, our viewpoint is that these costs are variable, and do fluctuate with the volume of leases that are written. If the volume of leases written decreases, so do the number of employees employed for this work, and vice versa; therefore these costs are variable and are not “unavoidable”.

Based on our discussions with our counterparts in the United States, it is our understanding that our accounting for similar costs is consistent with treatment under U.S. GAAP. ASC 840-20-25-18 states:

“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 lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to any of the following activities performed by the lessor:

- a. Advertising
- b. Soliciting potential lessees
- c. Servicing existing leases
- d. Other ancillary activities related to establishing and monitoring credit policies, supervision, and administration.”

As active observers in the joint IASB/FASB Leases project, it is our understanding that the definition of initial direct costs under IFRS in IAS 17 and U.S. GAAP in ASC 840 is not intended to differ from current practice or from one another.

In Agenda paper 11A of the March 22-23, 2011 meeting of the IASB/FASB, the staff recommendation is “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.” It was also noted that “(V)ery 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** (emphasis added) (see Appendix A for current guidance).” Appendix A of that Agenda paper notes that:

“Under the guidance in Topic 840, 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) Evaluating and recording guarantees, collateral, and other security arrangements
  - (iii) Negotiating lease terms
  - (iv) Preparing and processing lease documents
  - (v) Closing the transaction”

It is our understanding that the capitalization of initial direct costs related to certain salaried employees engaged in arranging and negotiating leases for commercial real estate transactions is consistent across Canada and the U.S. We therefore do not agree with the Interpretation Committee's conclusion that predominant practice is to expense employee salary costs.

Overall, we believe that IAS 17 is clear that certain internal costs do qualify as incremental costs and are directly attributable to negotiating and arranging a lease. We further believe that this accounting treatment is consistent with both IFRS under IAS 17 and U.S. GAAP under ASC 840.

We thank the IFRIC for considering our comments on the tentative decision regarding the meaning of incremental costs within the context of IAS 17 Leases. Please contact Nancy Anderson, REALpac's Vice President Financial Reporting & Chief Financial Officer at [nanderson@realpac.ca](mailto:nanderson@realpac.ca) or at 1-416-642-2700 ext. 226 if you would like to discuss our comments.

Respectfully submitted,



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