STAFF PAPER

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Project	**Leases**		
Paper topic	Initial direct costs		
CONTACT(S)	Anna Heining	aheining@ifrs.org	+44 (0)20 7246 6428
	Scott A. Muir	samuir@fasb.org	+1 (203) 956 3478
	Patrina Buchanan	pbuchanan@ifrs.org	+44 (0) 20 7246 6468

Objective

1. The purpose of this paper is to discuss which costs should be considered as initial direct costs and the accounting for those initial direct costs.

2. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Background

   (c) Summary of proposals in the 2013 *Leases* Exposure Draft (2013 ED)

   (d) Summary of feedback on the 2013 ED

   (e) Staff analysis and staff recommendations

   (f) Appendix A – Accounting for initial direct costs under existing guidance

Summary of staff recommendations

3. The staff recommend the following regarding the nature of initial direct costs:

   (a) Clarify in the final leases standard that only incremental costs would qualify as initial direct costs (ie an allocation of internal costs would be excluded from initial direct costs).

   (b) With respect to incremental costs:

      (i) Some staff recommend an incremental cost notion similar to that included in the forthcoming revenue recognition standard, ie initial direct costs would include only incremental costs that an entity would not have incurred if the lease had not been *obtained* (executed) (eg commissions or payments made to existing tenants to obtain the lease).

      (ii) Other staff recommend carrying forward the incremental cost notion in IAS 17 and define initial direct costs as 'costs that an entity would not have incurred if it had not *negotiated and arranged* a lease' (eg professional fees, as well as commissions or payments made to existing tenants to obtain the lease).

   (c) The staff recommend using the same definition of initial direct costs for both lessees and lessors.

4. The staff also recommend the following regarding the accounting for initial direct costs:

   (a) A lessor in a Type A lease (except those who recognise selling profit at lease commencement) would include initial direct costs in the initial measurement of the lease receivable by taking account of these costs in determining the rate implicit in the lease. Lessors who recognise selling profit at lease commencement should recognise initial direct costs associated with a Type A lease as an expense at lease commencement.

   (b) A lessor in a Type B lease should recognise initial direct costs as an expense over the lease term on the same basis as lease income. A lessee should include initial direct costs in the initial measurement of the right-of-use (ROU) asset and amortise those costs over the lease term.

Background

5. Existing U.S. GAAP leases guidance includes all of the following costs directly attributable to negotiating and arranging a lease as part of initial direct costs:
   - (a) Those that an entity would not have incurred if the lease had not been obtained (eg sales commission paid by a lessor);
   - (b) Those that an entity would not have incurred if the lease had not been negotiated and arranged (eg costs of tax or legal advice obtained by a lessee or a lessor when negotiating the terms and conditions of a lease); and
   - (c) Those directly related to negotiating and arranging a lease that an entity would have incurred even if the lease were not negotiated or arranged (eg an allocation of employees' compensation and payroll-related fringe benefits involved in negotiating and arranging leases).
6. Existing IFRS leases guidance includes *incremental* costs of negotiating or arranging a lease. Accordingly, it includes those costs in bullets (a) and (b) in the preceding paragraph but does not include, for example, an allocation of internal employee costs involved in negotiating and arranging leases.

Summary of proposals in the 2013 ED

7. The 2013 ED defined initial direct costs as 'costs that are directly attributable to negotiating and arranging a lease and would not have been incurred without entering into the lease'.
8. Additionally, the 2013 ED provided examples of initial direct costs within the Application Guidance:

> B10 […] Initial direct costs for a lessee or a lessor may include, for example, any of the following:

(a) commissions;

(b) legal fees;

(c) evaluating the prospective lessee's financial condition;

(d) evaluating and recording guarantees, collateral and other security contracts;

(e) negotiating lease terms and conditions;

(f) preparing and processing lease documents; and

(g) payments made to existing tenants to obtain the lease.

B11 Both of the following items are examples of costs that are not initial direct costs:

(a) general overheads, including, for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time; and

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

9. The 2013 ED proposed that a lessee would include initial direct costs incurred in the initial measurement of the right-of-use (ROU) asset and that a lessor would include initial direct costs incurred in the initial measurement of the lease receivable for a Type A lease. In a Type B lease, a lessor would recognise initial direct costs as an expense over the lease term on the same basis as lease income.

Summary of feedback on the 2013 ED

10. Very few constituents commented on the boards' proposals on the measurement of initial direct costs. Those constituents who did comment had the following concerns:

(a) Some indicated that the definition of initial direct costs in the 2013 ED appeared to be contrary to the examples provided in the Application Guidance.

(b) Some said that it is difficult to calculate initial direct costs. Consequently, the proposed guidance should apply only to initial direct costs that are material to the lease.

(c) Initial direct costs are incurred to initiate the lease. Accordingly, some constituents said that an entity should not include initial direct costs in the measurement of the ROU asset, but instead should recognise them as an expense in the period in which they are incurred.

Staff analysis and staff recommendations

Nature of costs included in initial direct costs

11. As mentioned above, some constituents indicated that the definition of initial direct costs did not appear to be aligned with the examples of initial direct costs in the 2013 ED. For example, the Application Guidance included costs such as those for negotiating lease terms and conditions, and those for preparing and processing lease documents. However, these costs would not appear to meet the threshold of 'would not have been incurred without *entering into* the lease'. This is because those activities are often performed by a lessor's employees, who would be paid the same salary regardless of whether a particular lease is originated (ie executed).

12. The staff think the boards should clarify in the final leases standard that only incremental costs would qualify as initial direct costs (ie an allocation of internal costs would be excluded from initial direct costs). The staff think that this is what the boards intended when using the phrase 'would not have been incurred without entering into the lease'.

13. With respect to incremental costs, the staff think there are two alternatives that the boards could consider:

    (a) **Approach 1** – An incremental cost notion similar to that included in the forthcoming revenue recognition standard, ie initial direct costs would include only incremental costs that an entity would not have incurred if the lease had not been obtained (eg commissions or payments made to existing tenants to obtain the lease).

    (b) **Approach 2** – An incremental cost notion consistent with the definition of initial direct costs in IAS 17, ie initial direct costs would include only incremental costs that an entity would not have incurred if it had not negotiated and arranged a lease (eg professional fees, *as well as* commissions and payments made to existing tenants to obtain the lease).

14. In the following paragraphs, the staff have analysed the approaches for lessees and lessors.

Approach 1

Lessor

15. Approach 1 would align the concept of initial direct costs in any final leases standard with the concept of 'incremental costs' in the forthcoming revenue recognition standard. Approach 1 is based on the rationale that similar costs incurred in similar circumstances should be accounted for consistently. Approach 1 views leasing transactions as fundamentally a revenue-generating activity for most lessors (even if the principal revenue stream is interest) in which they transfer a right to use an underlying asset to the lessee. Accordingly, accounting for initial direct costs in a manner similar to the accounting for such costs under the forthcoming revenue recognition standard may be the most appropriate approach.

16. According to the forthcoming revenue recognition standard, an entity would recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. Incremental costs of obtaining a contract are defined as 'costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained'.

17. Similarly, under Approach 1, initial direct costs would include only those costs that are incremental to obtaining a lease, such as commissions paid to agents (including employees acting as selling agents) or payments made to existing tenants. Costs that are incurred before a lease is signed, such as costs of obtaining tax or legal advice, would not qualify as initial direct costs. Approach 1 would, therefore, restrict the population of costs included as initial direct costs to a narrow population of costs incurred only as a result of *obtaining* the lease. Under Approach 1, initial direct costs

could be defined as ‘costs that an entity incurs to obtain a lease that it would not have incurred if the lease had not been obtained’.

18. In addition, the staff think the analysis of whether costs are ‘incremental’ should be independent of whether costs relate to a single lease or multiple leases. For example, an entity may pay an employee acting as a selling agent a commission of CU10,000 conditional on originating ten leases. In this example, the aggregate commission would qualify as an incremental cost to the lessor. The staff note however that the lessor would need to attribute the aggregate commission to each lease, or portfolio of leases, on a systematic basis for purposes of subsequent measurement.

19. The staff think Approach 1 would be simpler for lessors compared to existing guidance, and in particular existing U.S. GAAP guidance, which requires an entity to allocate employees' compensation and payroll-related fringe benefits to a particular lease and includes those as initial direct costs. Allocating internal costs requires an entity to track employee time spent on negotiating and arranging leases.

Lessee

20. Under Approach 1, the staff considered, but rejected, aligning the definition of a lessee’s initial direct costs with the definition of other acquisition costs for nonfinancial assets such as property, plant, and equipment. Under existing IFRS and U.S. GAAP, the costs of an item of property, plant, and equipment include directly attributable costs such as professional fees and internal costs (eg employee salaries and benefits) arising directly from the acquisition of the item of property, plant, and equipment. Consequently, aligning the definition of initial direct costs in the final leases standard with that for acquisition costs under existing IFRS and U.S. GAAP guidance on property, plant, and equipment would include a cost notion that is broader than ‘incremental’.

21. Although such an approach would provide comparability of such costs for assets that are owned and those that are leased for a lessee, the staff recommend using the narrower definition proposed for lessors that would include only costs that are incremental to obtaining a lease for the following reasons:

(a) An incremental cost notion would be less complex and therefore less costly to apply than an approach that would require an allocation of internal costs.

(b) In terms of benefits, the staff think for many leases there may be very little initial direct costs in any event. Accordingly, defining initial direct costs narrowly may not result in very significant differences in amounts recognised for many leases.

(c) The staff think that it would be confusing to include two separate definitions of *initial direct costs* in the final leases standard (one for lessors and one for lessees).

Approach 2

22. Similarly to Approach 1, under Approach 2, initial direct costs would also be based on an incremental cost notion and would not require an allocation of internal costs. Nonetheless, under Approach 2, the definition of initial direct costs would be broader than under Approach 1. In addition to the costs included under Approach 1, Approach 2 would also include costs that are incremental to the *process* of obtaining a lease, such as fees paid for legal or tax advice obtained when negotiating a lease. Under Approach 2, initial direct costs could be defined as 'costs that an entity incurs to negotiate and arrange a lease that it would not have incurred if the lease had not been negotiated and arranged'.

23. The staff note that the definition of initial direct costs, as suggested under Approach 2, would result in outcomes consistent with the existing definition of initial direct costs in IAS 17. Paragraph 38 of IAS 17 describes initial direct costs for a lessor as 'amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease'. IAS 17 does not include a definition of 'incremental'. In March 2014, the IFRS Interpretations Committee's (the 'Interpretations Committee') discussed the meaning of incremental costs in the context of IAS 17 *Leases*.[1] The Interpretations Committee noted that only those costs

[1] The Interpretations Committee discussed whether internal fixed costs qualify as 'incremental costs', in particular whether salary costs of permanent staff involved in negotiating and arranging new leases as a lessor

that would not have been incurred if the entity had not negotiated and arranged a lease should be considered to be initial direct costs. A portion of an employee's salary costs relating to time spent in originating a new lease would not qualify as 'incremental costs'. Such costs would be incurred regardless of whether an entity negotiates and arranges the lease.

24. Additionally, the staff think paragraph 18 of this paper should also apply under Approach 2, ie costs could be 'incremental' to a single lease or multiple leases.

25. Similarly to Approach 1, the staff suggesting Approach 2 recommend using the same definition of initial direct costs for lessees and lessors for the reasons explained in paragraph 21 of this paper.

26. Approach 2 retains the concept that costs that are directly related to negotiating and arranging a lease would be included as initial direct costs without adding the complexity of requiring an entity to allocate a portion of internal costs to a lease. Consequently, Approach 2 is the same as the existing definition of initial direct costs in IAS 17 and closer than Approach 1 to the existing definition in Topic 840. The Approach 2 definition is also closer than Approach 1 to the definition of acquisition costs for other nonfinancial assets—the principal difference relates to the allocation of internal costs.

Staff recommendation

27. The staff recommend clarifying in the final leases standard that only incremental costs would qualify as initial direct costs (ie an allocation of internal costs would be excluded from initial direct costs).

28. With respect to incremental costs:

(a) Some staff suggest Approach 1 in this paper—an incremental cost notion similar to that included in the forthcoming revenue recognition standard, ie initial direct costs would include only incremental costs that an entity would not have incurred if the lease had not been obtained (eg commissions

qualify as 'incremental costs'. The paper can be found here: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/November/AP07%20-%20IAS%2017%20incremental%20costs.pdf or payments made to existing tenants to obtain the lease). Those staff think that it is appropriate for the definition of initial direct costs associated with a lease from a lessor's perspective to be consistent with the definition of incremental costs associated with a revenue contract.

(b) Other staff suggest Approach 2 in this paper—carrying forward the incremental cost notion in IAS 17, which would define initial direct costs as 'costs that an entity would not have incurred if it had not negotiated and arranged a lease'. Those staff think that, for both lessees and lessors, it is appropriate to include costs, such as those incurred for legal and tax advice, directly related to negotiating and arranging a lease as initial direct costs, and typically recognise them as an expense over the lease term. They think that a narrower definition would result in little, if any, initial direct costs being recognised by a lessee, which would in their view call into question the need for the requirement for lessees.

29. Under either approach the boards may take, the staff think that it would add complexity to the leases standard to have a different definition of initial direct costs for lessees and lessors. Therefore, the staff recommend that both lessees and lessors should apply the same definition of initial direct costs.

Question 1-3: Nature of costs included in initial direct costs
Question 1 – Do the boards agree with the staff recommendation that initial direct costs should include only those costs that are incremental (ie should not include an allocation of internal costs)? Question 2 – Which approach to defining 'incremental costs' (Approach 1 or Approach 2) do the boards prefer? Question 3 – Do the boards agree that both lessees and lessors should apply the same definition of *initial direct costs*?

Accounting for Initial Direct Costs

Lessor – Type A leases

30. The 2013 ED proposed that a lessor would include initial direct costs incurred in the initial measurement of the lease receivable for Type A leases.

31. At the April 2014 board meeting, the boards decided to include those initial direct costs of the lessor that are eligible for capitalisation in determining the rate implicit in the lease. Such an approach would be consistent with existing lessor guidance under IFRS.

32. This decision means that a lessor would include initial direct costs in the initial measurement of the lease receivable by taking account of these costs in determining the rate implicit in the lease.

33. Consistent with existing lessor accounting under IFRS and U.S. GAAP, the staff think that a lessor should not capitalise initial direct costs if it recognises selling profit on the underlying asset at lease commencement. Instead, a lessor should recognise as an expense initial direct costs associated with Type A leases for which the lessor recognises selling profit at lease commencement. The staff note that this accounting result would be consistent with the forthcoming revenue recognition guidance in that an entity would recognise as an expense any commission earned on the sale of a good when the good is transferred to the customer.

Lessor – Type B leases

34. The 2013 ED recommended that a lessor should recognise initial direct costs as an expense over the lease term on the same basis as lease income. This is consistent with existing guidance for operating leases under IFRS and U.S. GAAP.

35. The staff recommend carrying forward this requirement.

Lessee

36. The 2013 ED proposed that a lessee would include initial direct costs in the initial measurement of the ROU asset. A lessee would present initial direct costs as part of the ROU asset and amortise it typically on a straight-line basis. This is consistent with

existing guidance for initial direct costs incurred by the lessee in a finance lease under IFRS and U.S. GAAP.

37. The staff think that the feedback received on the 2013 ED indicates that the boards should not reconsider their previous decision on the recognition of a lessee's initial direct costs. Accordingly, the staff recommend that a lessee should include initial direct costs in the initial measurement of the ROU asset and amortise them as part of the ROU asset for both Type A and Type B leases.

38. Additionally, the staff think that any additional costs associated with a lease modification (such as fees for amending the contract) that meet the definition of initial direct costs should be included in the measurement of the new ROU asset (if the lease modification is a separate new lease) or the adjustment to the ROU asset (if the lease modification is not accounted for as a separate new lease).

39. The staff recommend the following regarding the accounting for initial direct costs:

    (a) A lessor in a Type A lease (except those who recognise selling profit at lease commencement) would include initial direct costs in the initial measurement of the lease receivable by taking account of these costs in determining the rate implicit in the lease. Lessors who recognise selling profit at lease commencement should recognise initial direct costs associated with a Type A lease as an expense at lease commencement.

    (b) A lessor in a Type B lease should recognise initial direct costs as an expense over the lease term on the same basis as lease income. A lessee should include initial direct costs in the initial measurement of the right-of-use (ROU) asset and amortise those costs over the lease term.

Question 4: Accounting for initial direct costs
Question 4 – Do the boards agree with the staff recommendations on the accounting for initial direct costs?

Appendix A – Accounting for initial direct costs under existing guidance

A1. This appendix summarises the existing guidance for the definition of initial direct costs under IFRS (IAS 17) and U.S. GAAP (Topic 840).

IFRS

A2. 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.

A3. 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 recognised as an asset.

A4. 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.

A5. 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 recognised as an expense when the selling profit is recognised, which is normally at the commencement of the lease term for a finance lease.

U.S. GAAP

A6. 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.

A7. 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.

A8. 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.'