

## STAFF PAPER

March 2014

## IFRS Interpretations Committee Meeting

<b>Project</b>	<b>IAS 17 Leases</b>		
<b>Paper topic</b>	Review of the tentative agenda decision		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

## Introduction

1. In November 2013, the IFRS Interpretations Committee (the Interpretations Committee) discussed a request for clarification about *IAS 17 Leases*. The submission related to the meaning of ‘incremental costs’ within the context of IAS 17. The submitter asked whether the salary costs of permanent staff involved in negotiating and arranging new leases (and loans) would 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.
2. Our analysis of this issue was discussed in Agenda Paper 7 of the November 2013 meeting, *IAS 17 Leases: Meaning of ‘incremental costs’*. A link to this paper is included in the footnote below.<sup>1</sup>
3. The Interpretations Committee tentatively decided that they would not add this topic to its agenda because the requirements in IAS 17 for the accounting of initial direct costs would be sufficient and the outreach performed indicated that there would be no diversity in practice. The Interpretations Committee also noted that the IASB is currently undertaking a project on leases. The Interpretations

<sup>1</sup> Agenda paper November 2013

<http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/November/AP07%20-%20IAS%2017%20incremental%20costs.pdf>

Committee concluded that 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the IASB's final Standard on leases, it might not be efficient to provide an Interpretation of a Standard that will be superseded. The extract from *IFRIC Update* November 2013 is included below for convenience:

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.

4. The agenda decision, in the form proposed for finalisation, is included in Appendix A.

### **Comment letter summary and staff analysis**

5. The comment period for the tentative agenda decision ended on 20 January 2014. We received three responses. These comment letters are attached as Appendices B–D.
6. Two respondents, the staff of the Canadian Accounting Standards Board (AcSB) and Deloitte, agreed with the Interpretations Committee's tentative agenda decision not to add the item to its agenda for the reasons provided in the agenda decision.
7. Nonetheless, the AcSB and Deloitte recommended the following changes to the wording of the tentative agenda decision:

- (a) The AcSB suggested that “there does not appear to be *significant* diversity in practice on this issue”. This is because the AcSB reported that they have seen limited diversity in practice. They also think that the issue having been raised at the Interpretations Committee suggests some diversity in practice.
- (b) Deloitte suggested that the agenda decision should state that “the term ‘incremental costs’ is expected to be applied consistently in the context of finance lease receivables and other financial assets”. This is because the definition of incremental costs in IAS 17, included in the tentative agenda decision, was drawn from the definition of transaction costs included in IAS 39 *Financial Instruments: Recognition and Measurement*.
8. We accept the AcSB’s comment that there is some limited diversity in practice. Accordingly, as upon the AcSB’s request, we suggest changing the wording of the tentative agenda decision to include the word significant, ie “there does not appear to be significant diversity in practice on this issue”.
9. We do *not* recommend making the change suggested by Deloitte for the following reason. In the November 2013 paper, we used the definition of ‘incremental’ within the guidance on transaction costs in IAS 39 as analogy to incremental costs within IAS 17 (see paragraph 21-24 of the 2013 November paper). Nonetheless, we do not think that it is the IASB’s intention to create a direct link between incremental costs in IAS 17 and IAS 39. This is because, the term ‘incremental’ is used with similar but not identical meanings in the different Standards.
10. The third respondent, EY, disagreed with the tentative agenda decision not to add the issue to the Interpretations Committee’s agenda for the following reasons:
- (a) Insufficient guidance in IAS 17 – EY disagreed that the requirements in IAS 17 for the accounting of initial direct costs is sufficient. In EY’s view, IAS 17 would not be clear that particular internal fixed costs would not qualify as incremental costs, because:

- (i) paragraph 38 of IAS 17 would indicate that some internal costs are incremental; and
- (ii) existing IFRS, and IAS 17 in particular, would not explicitly exclude internal fixed costs from qualifying as incremental costs.

EY agreed with View B expressed in the 2013 November paper that particular internal fixed costs could be considered ‘incremental’. This is because these costs are directly related to specific activities performed by the lessor that would not have occurred but for that successfully executed lease. These activities would be initiated upon the prospective lessee’s desire to enter into a lease and would relate directly to entering into the successfully executed lease.

- (b) Diversity in practice – EY disagrees that there does not appear to be diversity in practice on this issue. EY contended that they have seen diversity in practice across multiple geographic areas (ie Australia, Europe and North America).
- (c) The 2008 IFRIC Update – EY noted that the IASB has not acted upon the Interpretations Committee’s recommendation from September 2008 that common definitions of ‘incremental’ and ‘directly attributable’ be developed. In the *2008 IFRIC Update* “...the IFRIC also noted that the terms ‘incremental’ and ‘directly attributable’ are used with similar but not identical meanings in many Standards and Interpretations. The IFRIC recommended that common definitions should be developed for both terms and added to the Glossary as part of the Board’s annual improvements project.”

11. For the reasons explained above in paragraph 10, EY concluded that additional guidance as to which internal costs qualify as incremental would be useful for preparers. EY, therefore, suggested adding the issue to the Interpretations Committee’s agenda.
12. We do *not* recommend making the change suggested by EY for the following reasons:

- (a) Insufficient guidance in IAS 17 – We note that the Interpretations Committee considered this point in their discussion of the topic in November 2013. The Interpretations Committee noted that internal costs could qualify as initial direct costs if they are incremental. The Interpretations Committee concluded from the definition of ‘incremental’ by analogy with IAS 39 that incremental cost should be interpreted as costs that would not have been incurred if the entity had not negotiated and arranged a lease. The Interpretations Committee noted that the internal fixed costs would *not* have been caused by negotiating and arranging a lease because they would have been incurred in any event. The Interpretations Committee therefore concluded that internal fixed costs are not ‘incremental’.
- (b) Diversity in practice – Notwithstanding EY’s concern about diversity in practice, our outreach performed on this issue has shown that the predominant practice is to expense internal fixed costs. As described in paragraph 14-19 of the 2013 November paper, we received 18 responses to our outreach request (13 responses from national standard-setters, four responses from the large international audit networks and two responses from regulators). All but one of the respondents reported that they do not see diversity in practice regarding the issue raised by the submitter. Most respondents think that fixed costs are unavoidable regardless of whether a lease is negotiated or arranged and concluded that fixed costs are not ‘incremental’.
- (c) The 2008 IFRIC Update – We note that the Board has not added the issue to its agenda.
13. Two respondents, the staff of the AcSB and EY, referred to the guidance proposed in 2013 Exposure Draft *Leases* (the 2013 ED). In their comment letter, the staff of the AcSB noted that “describing incremental costs as “costs that would not have been incurred if the entity had not negotiated and arranged a lease” is consistent with paragraph B10 of ED/2013/6 on Leases and we agree with that description”. In its comment letter EY noted the following:

The IASB and FASB staffs issued agenda paper 11A for the 21-23 March 2011 joint meeting addressing the definition of initial direct costs for the joint project on leasing. On page 4, paragraph 14 of this agenda paper, the staffs note that the definition proposed for the joint exposure draft *Leases* is not intended to change current practice for how initial direct costs are defined. ASC 840-20-25-18 permits “that portion of employees’ total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease...” to be included in initial direct costs of a lease. We believe the staffs’ paper suggests there is no difference between IFRS and US GAAP currently, which is consistent with our observations in practice. Therefore, we believe the Interpretations Committee’s tentative agenda decision as drafted would create an IFRS/US GAAP difference.

14. We note that the application of incremental cost within IAS 17 should be based on existing requirements (not proposed requirements). The existing requirements were the basis for the Interpretations Committee’s conclusion in November 2013.

### **Staff summary**

15. As upon the AcSB’s request, we suggest changing the wording of the tentative agenda decision to include the word significant, ie “there does not appear to be significant diversity in practice on this issue”.
16. We do *not* recommend making the change suggested by Deloitte for the reasons given in paragraph 9.
17. We do *not* recommend making the changes suggested by EY for the reasons given in paragraph 12.

**Staff recommendation**

18. We recommend confirming the tentative agenda decision as worded in the November 2013 *IFRIC Update* but suggest adding the word significant such that there does not appear to be significant diversity in practice on this issue. The full text of the suggested agenda decision is included as Appendix A.

**Question for the Interpretations Committee**

1. Does the Interpretations Committee agree with the staff's recommendation to confirm not to take the issue on its agenda?
2. Appendix A includes the staff's proposed wording for the agenda decision. Does the Interpretations Committee agree with that wording?

## Appendix A

### Finalisation of agenda decision

A1. We recommend to make the following change to the original 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 significant 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.