



Implementation Considerations for Leases: Initial Direct Costs

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As financial institutions work toward successful implementation of Accounting Standards Codification Topic 842, *Leases* (ASC 842), one area that may be of particular importance is accounting for the initial direct costs of obtaining a lease. Under legacy ASC Topic 840, *Leases* (ASC 840), initial direct costs of obtaining a direct financing lease are capitalized and included in the net investment in the lease and amortized over the term of the lease by the lessor. These include costs to originate a lease where the cost results directly from and is essential to acquiring the lease and costs that would not have been incurred had the leasing transaction not occurred. ASC 840 limits these costs to certain costs directly related to specific activities performed by the lessor. However, under ASC 842, initial recognition of similar direct costs may differ, primarily regarding which costs qualify for deferral. This is a result of the change in definition of what constitutes an initial direct cost in ASC 842 vs. ASC 840.

ASC Subtopic 310-20 provides the primary guidance in accounting for loan origination costs. These costs include the incremental direct costs of loan origination and certain costs directly related to specified activities performed by the lender such as evaluating a prospective borrower's financial condition, evaluating and recording guarantees, collateral, and other security arrangements, negotiation of loan terms, etc.

The definition of direct loan origination costs in ASC Subtopic 310-20 also applies to lessors in determining the net amount of initial direct costs of entering into a lease. With a consistent definition of these costs under ASC Subtopic 310-20 and ASC Topic 840, many financial institutions have used similar

calculations for loan origination and initial direct lease costs. ASC 842 narrows the definition of initial direct costs incurred, which will likely lead to the need for separate calculations for leases vs. loans. Initial direct costs are limited under ASC 842 to only those costs that would not have been incurred if the lease had not been obtained. Initial direct costs under ASC 842, for example, may include commissions or payments made to an existing tenant to incentivize that tenant to terminate its lease. These costs would only be incurred as a result of lease execution.

Historically the definition of direct loan origination costs was consistent with that of initial direct costs of entering into a lease. Under ASC 842, the definitions will no longer align, and financial institutions will likely need to maintain separate calculations for loans vs. leases.

Costs incurred to arrange or negotiate a lease that would be incurred regardless of whether the lease was ultimately executed do not qualify as initial direct costs under ASC 842, whereas they may have been permissible to include in initial direct costs under ASC 840. Examples of such costs include lease underwriting, fixed employee salaries, costs for legal advice and negotiating lease terms, and costs of evaluating potential lessee financial condition. Such costs would likely be incurred by the Company even if the potential lessee decided not to execute the lease, and therefore do not qualify as initial direct costs under ASC 842.

ASC Topic 842, *Leases*, is effective for public business entities, certain not-for-profit entities and certain employee benefit plans for annual periods beginning after Dec. 15, 2018, and interim periods within those years. The effective date for all other entities is annual periods beginning after Dec. 15, 2019, and interim periods in the following year.

About the Author

Rob Cherry is a senior manager in DHG's Professional Standards Group where he serves as a technical resource for complex accounting and auditing matters. In this role, he provides guidance to engagement teams on recent accounting and auditing pronouncements, presents at firm-wide trainings and performs reviews of various consultations and engagements as part of the firm's quality control process.

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ASC TOPIC 842

Initial direct costs are incremental costs of a lease that would not have been incurred had the lease not been obtained. Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained are not initial direct costs.



ASC Subtopic 310-20 (and ASC Topic 840)

Direct loan (lease) origination costs represent costs associated with originating a loan (lease). Direct loan (lease) origination costs of a completed loan (lease) shall include only the following:

- Costs to originate a loan (lease) that have both of the following:
 - » Result directly from and are essential to the lending (leasing) transaction
 - » Would not have been incurred by the lender (lessor) had the transaction not occurred
- Certain costs directly related to specified activities performed by the lender (lessor) for that loan (lease). These activities include all of the following:
 - » Evaluating the prospective borrower's (lessee's) financial condition
 - » Evaluating and recording guarantees, collateral, and other security arrangements
 - » Negotiating loan (lease) terms
 - » Preparing and processing loan (lease) documents
 - » Closing the transaction