Letting fees

Real Estate hot topics

Definition

Initial direct costs are often incurred by lessors in negotiating and arranging a lease. They are defined as ...incremental costs that are directly attributable to negotiating and arranging a lease...' [IAS 17.4].

Under this definition, only incremental costs may be treated as initial direct costs. Internal costs that are not incremental – such as administration, selling expenses and general overheads – should be written off as incurred. Incremental external costs in the form of commission, legal, arrangement and brokers' fees normally qualify as initial direct costs.

Recognition and measurement

Initial direct costs incurred by lessors in negotiating and arranging a finance lease are included in the initial measurement of the finance lease receivable[1]. The definition of the interest rate implicit in the lease ensures that initial direct costs are automatically included in the finance lease receivable. There is no need to add them separately [IAS 17.38]. Including initial direct costs in the measurement of the finance lease receivable reduces the amount of income recognised over the lease term.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and are recognised as an expense over the lease term on the same basis as the lease income [IAS 17.52]. It is important to amortise initial direct costs separately from the asset, as they will be recognised as an expense over the lease term rather than over the life of the asset. The lease term is likely to be a significantly shorter period than the life of the asset.

Recognition of initial direct costs as an immediate expense is not acceptable.

As explained above, letting fees paid to agents that meet the definition of 'initial direct costs' under IAS 17 should be added to the carrying amount of the leased asset and recognised over the lease term on the same basis as the lease income [IAS 17.52]. The letting fees incurred are therefore added to the carrying amount of the leased asset together with any other lease-related initial direct costs and presented in the same line as the leased asset.

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset, together with any future terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

1. This does not apply to manufacturers or dealer lessors

January 2010

Accounting principles

The following table presents the principles of accounting for fees paid to external agents (letting fees) in different scenarios:

1. Letting fees incurred during the construction/development phase

Background		
Entity A starts the construction of a property that will be leased out under operating lease agreements after completion. During the construction, Entity A pays letting fees to an agent for attracting Lessee B. The lease with Lessee B has a term of five years. The letting fees paid to the agent are directly attributable to the lease agreement with Lessee B.	The letting fees incurred during construction are costs associated with negotiating and arranging an operating lease; they should therefore be added to the carrying amount of the leased asset and recognised as an expense over the lease term of five years [IAS 17.52]. Entity A should start to amortise the letting fees paid from the day the lease commences (see second scenario). Measurement at initial recognition: Letting fees incurred [IAS 17.52] plus the cost of the construction [IAS 40.20].	
	Fair value model	**Cost model**
	Subsequent measurement (during the construction phase):	Subsequent measurement (during the construction phase):
	Fair value of the property under construction, which includes letting fees incurred [IAS 40.30 in connection with IAS 40.33].	Letting fees incurred plus cost less impairment of the property under construction [IAS 40.30 in connection with IAS 16.30].
	Effect on income statement in subsequent periods (during the construction phase):	Effect on income statement in subsequent periods (during the construction phase):
	Fair value change of the property.	Impairment charges, if applicable.
	Subsequent measurement (after the completion of the construction):	Subsequent measurement (after the completion of the construction):
	See scenario 2 below.	See scenario 2 below.

2. Letting fees incurred for first time leases after acquisition of a new building which is available for immediate use as investment property

Background		
Entity C purchased a new build property, which C intends to lease out under operating lease agreements. Entity C pays letting fees to an agent for attracting Lessee D. The lease with Lessee D terminates after five years, with an extension option of two years under the same conditions and with no additional payments required. It is reasonably certain that D is going to exercise the option.	The letting fees incurred are costs associated with negotiating and arranging an operating lease; they should therefore be capitalised and recognised over the lease term of seven years [IAS 17.52]. Measurement at initial recognition: Letting fees incurred [IAS 17.52] plus the cost of the construction [IAS 40.20].	
	Fair value model	**Cost model**
	Subsequent measurement:	Subsequent measurement:
	Fair value[1] of the property, which includes the letting fees incurred amortised over the lease term of seven years [IAS 40.30 and IAS 40.33] (see example below).	Remaining unamortised balance of letting fees incurred plus the cost of the property less accumulated depreciation and any accumulated impairment loss [IAS 40.30 and IAS 16.30].
	Effect on income statement in subsequent periods:	Effect on income statement in subsequent periods:
	Amortisation of the capitalised letting fee for the period; and fair value change[2] of the property.	Amortisation of the capitalised letting fee and depreciation of the property for the period; and if applicable, the impairment amount.

1 The fair value is determined at each year end based on a valuation. This should take into account all factors that affect the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

2 The fair value change is effectively the balancing figure, which is determined by the valuations at the opening and closing balance sheet dates, and taking into account other movements such as additions, disposals, and capitalisation and amortisation of letting fees.

Practical example

Entity Z acquires a vacant property for a total consideration of C158 at 01/01/X1. At that date, Z pays Agent X a letting fee of C3 in connection with negotiating a lease contract with Lessee Y. The lease term is three years. Z capitalised the letting fee incurred within the carrying amount of the investment property, and amortised on a straight-line basis over the lease term of three years. The building itself is depreciated over 40 years[2]. At the end of the three year lease, Z again pays agent X a letting fee of C5 to negotiate a new five-year lease with Lessee Y. For simplicity, it is assumed that there are no movements due to other acquisitions, additions, disposals or transfers.

	Cost model	Fair value model	
Acquisition cost of the property	158	158	Acquisition cost
Capitalised letting fees	3	3	
Depreciation of building	(4)	-	Depreciation over 40 years
Amortisation of capitalised letting fees	(1)	(1)	Amortisation over 3 years
Fair value gains/(losses)	-	(0.3)	(159.7 - 158 - 3 + 1 = -0.3). The FV gain/(loss) illustrated is effectively the balancing figure to arrive at the valuation estimated by external valuers at the balance sheet date
Carrying value at 01/01/X2	156	159.7	Fair value of property at year end according to the valuation report = 159.7
Depreciation of building	(4)	-	Depreciation over 40 years
Amortisation of capitalised letting fees	(1)	(1)	Amortisation over 3 years
Fair value gains/(losses)	-	0.1	(158.8 – 159.7 + 1 = 0.1) The FV gain/(loss) illustrated is effectively the balancing figure to arrive at the valuation estimated by external valuers at the balance sheet date
Carrying value at 01/01/X3	151	158.8	Fair value of property at year end according to the valuation report = 158.8
Depreciation of building	(4)	-	Depreciation over 40 years
Amortisation of capitalised letting fees	(1)	(1)	Amortisation over 3 years
Fair value gains/(losses)	-	0.3	(158.1 - 158.8 + 1 = 0.3) The FV gain/(loss) illustrated is effectively the balancing figure to arrive at the valuation estimated by external valuers at the balance sheet date
Carrying value at 01/01/X4	146	158.1	Fair value of property at year end according to the valuation report = 158.1
Capitalised letting fees	5	5	
Depreciation of building	(4)	-	Depreciation over 40 years
Amortisation of capitalised letting fees	(1)	(1)	Amortisation over 5 years
Fair value gains/(losses)	-	(3.4)	(158.7 – 158.1 - 5 + 1 = -3.4) The FV gain/(loss) illustrated is effectively the balancing figure which is directly determined by the valuation obtained by external valuers at the balance sheet date
Carrying value at 01/01/X5	146	158.7	Fair value of property at year end according to the valuation report = 158.7
etc.			

Entities should consider disclosure in the notes to the financial statements of the treatment of letting fees and the movements in the carrying amount of the property that relate to the initial payment or subsequent amortisation of letting fees.

2. For simplicity the depreciation change has been determined for the building as a whole.

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