Project **Leases**

Topic **Initial direct costs**

Objective

1. The purpose of this paper is to determine how to account for costs incurred by lessees when negotiating and arranging leases (initial direct costs). In March 2009, a Discussion Paper on Leases was published without any preliminary views on this issue.
2. At this meeting, the staff recommends including initial direct costs in the carrying amount of the right-of-use asset recognised by the lessee. These costs would be amortised with that asset.
3. The paper contains:
   a. Background information;
   b. Staff analysis on three possible approaches; and
   c. Staff recommendation.

Background

4. Lessees often incur costs when negotiating and arranging leases (for example, commissions, legal fees and internal costs). Existing standards refer to these costs as initial direct costs. In general, initial direct costs include only those incremental costs that are directly attributable to negotiating and arranging a lease.
5. At present, initial direct costs that are incurred when arranging a finance lease are added to the amount recognised as an asset by the lessee and amortised with that asset.

Staff Analysis

6. There are three possible ways of addressing how initial direct costs should be accounted for:
   (a) Add initial direct costs to the carrying amount of the right-of-use asset
   (b) Allocate initial direct costs between debt issuance costs and asset acquisition costs
   (c) Recognise such costs as an expense as incurred.

Add initial direct costs to the carrying amount of the right-of-use asset

7. The boards could decide to add initial direct costs to the carrying amount of the right-of-use asset. The staff identified the following advantages of this approach:
   (a) It is consistent with the treatment of the costs associated with acquiring other non-financial assets (eg property, plant and equipment or intangible assets). Consequently, it increases comparability between non-financial assets.
   (b) It is consistent with the proposed amortised cost-based approach to measurement of the right-of-use asset. The boards have tentatively decided to initially measure the right-of-use asset at cost. In general, cost includes incremental costs directly attributable to acquisition of the asset.
   (c) The treatment makes sense because of the similarities between the right to use and the underlying leased item. The lessee uses the right-of-use asset (leased motor vehicle) the same way that it uses an owned asset (owned motor vehicle) in its normal course of business. The rights conveyed in a lease contract are similar to the rights obtained from owning the underlying asset for less than its useful life.
   (d) It avoids the need to justify why different treatments are necessary between leased assets and owned assets in the proposed new standard.

Allocate initial direct costs between debt issuance costs and asset acquisition costs

8. The second approach is to allocate initial direct costs between costs associated with issuing the obligation to pay rentals (debt issuance costs) and costs associated with acquiring the right-of-use asset. That is, asset acquisition costs could be capitalised

or expensed and debt issuance costs could be included in the carrying amount of the obligation to pay rentals or expensed. The staff identified the following advantages of this approach:

(a) It would permit the boards to treat similar costs similarly. That is, asset acquisition costs and debt issuance costs could be accounted for in the same way as similar costs incurred in other transactions (eg acquisition of a non-financial asset or issuance of debt).

(b) It reflects the view that an obligation to pay rentals is similar to a secured borrowing.

9. However, there are disadvantages to this approach. They include:

(a) Allocating initial direct costs to the two components would be more costly and complex for preparers.

(b) Not all lease contracts give rise to debt issuance costs (for example, many short term leases). Determining whether a cost is a debt issuance cost or an asset acquisition cost may be difficult for many leases.

Recognise such costs as an expense as incurred

10. The boards could decide to recognise all such costs as an expense as incurred. This treatment is consistent with the accounting for transaction costs arising in business combinations and arising on the acquisition of some financial instruments that are measured initially at fair value.

11. It can be argued that initial direct costs are not part of the exchange between the lessor and lessee; rather the costs arise from separate transactions in which the lessee pays for services received. The benefits obtained from incurring those costs are consumed as the services are received.

12. As a result, initial direct costs do not generally meet the definition of an asset. Paragraph 90 of the Framework provides specific guidance for the recognition of assets and states that an asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement.

13. Because of the reasons described above, the boards concluded as part of their deliberations on IFRS 3 and SFAS 141 to require all acquisition-related costs in a

business combination to be recognised as an expense. The IASB noted that this is inconsistent with the cost accumulation approaches in other standards (eg IAS 16 and IAS 38). However, the boards tentatively decided not to revise those standards at that point.

Staff Recommendation

14. The staff recommends approach (a). That is, to add initial direct costs in the carrying amount of the right-of-use asset recognised by the lessee and amortise those costs with that asset. The staff thinks that this approach provides useful information to users because it is the way similar costs are treated on the acquisition of other non-financial assets.
15. The staff does not recommend approach (b) because this approach would add complexity to the proposed new standard. The staff acknowledges that costs of negotiating and arranging leases may not meet the definition of an asset if viewed in isolation. However, because expensing initial direct costs as incurred is inconsistent with the amortised cost-based approach to initial measurement adopted by the boards, the staff does not recommend approach (c).

Question
Do the boards agree with the staff recommendation to add initial direct costs to the carrying amount of the right-of-use asset recognised by the lessee and amortised with that asset. If you disagree, please explain why.