

**FASB Emerging Issues Task Force**

**Issue No.** 05-3

**Title:** Accounting for Rental Costs Incurred During the Construction Period

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**Dates previously discussed:** None

**Previously distributed EITF materials:** None

**References:**

FASB Statement No. 13, *Accounting for Leases* (FAS 13)

FASB Statement No. 23, *Inception of the Lease* (FAS 23)

FASB Statement No. 34, *Capitalization of Interest Cost* (FAS 34)

FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FAS 67)

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91)

FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases* (FTB 88-1)

AICPA Statement of Position 98-5, *Reporting on the Costs of Start-Up Activities* (SOP 98-5)

AICPA Technical Practice Aids, Section 5600, "Leases" (TPA 5600)

AICPA proposed Statement of Position, *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment (proposed SOP on certain costs and activities related to property, plant, and equipment)*

EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction" (Issue 97-10)

EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (Issue 01-8)

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**\* The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

## Background

1. In some lease arrangements, an entity (lessee) may take possession of or be given control of leased property prior to that entity commencing operations or making rental payments under the terms of the lease. The leased property may include both land and building(s). During this period, the entity has the right to use the leased property for purposes of the construction of an asset (for example, leasehold improvements). After construction is completed, the entity commences operations and is required to make rental payments in accordance with the terms of the lease. Alternatively, some lease arrangements may require the lessee to make rental payments when the lessee takes possession of or is given control of the leased property.

2. FTB 88-1 requires rental costs associated with operating leases to be allocated on a straight-line basis to periods beginning when the lessee takes possession of or is given control of the leased property, regardless of when (a) the lessee's operations commence or (b) the lessee is required to make payments under the terms of the lease.<sup>1</sup>

3. For example, on January 1, 2005, a lessee enters into a lease arrangement and is given control of the leased asset in order to construct improvements and to otherwise ready the property for the lessee's intended use. The lessee is required to make rental payments to the landlord beginning on July 1, 2005, at which time the lessee is expected to commence operations. In this example, the lessee would allocate rental costs on a straight-line basis over the lease term beginning on January 1, 2005, because that is the date on which the lessee is given control of the leased asset.

4. Constituents have asked whether rental costs associated with ground and building leases that are incurred during the construction of an asset that is directly related to the leased property (that is, rental costs incurred during the construction period)<sup>2</sup> may be capitalized. Divergent views

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<sup>1</sup> For purposes of lease classification, *inception of the lease* is defined in FAS 23 as "the date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition." The inception of the lease may or may not be the date the lessee is given control of the leased asset.

<sup>2</sup> *Rental costs incurred during the construction period* refers to those costs that are paid in or allocated to the construction period.

exist regarding this issue. Some believe that both building and ground lease rental costs incurred during the construction period may be capitalized (that is, ground lease rental costs may be capitalized as a cost of buildings and building lease costs may be capitalized into the cost of leasehold improvements). Some believe that all rental costs incurred during the construction period must be expensed. Some believe that only rental costs related to ground leases may be capitalized (that is, only ground lease rental costs may be capitalized as a cost of buildings).

## **Scope**

5. This Issue addresses whether an entity may capitalize rental costs that are incurred during the construction period and, if so, the types of rental costs that are capitalizable. This Issue does not address rental costs other than those associated with building and ground operating leases.

## **Accounting Issues and Alternatives**

**Issue: Whether an entity may capitalize rental costs associated with ground and building operating leases that are incurred during the construction period.**

*View A: An entity may capitalize rental costs associated with ground and building operating leases that are incurred during the construction period.*

6. Proponents of View A believe that rental costs incurred during the construction of a long-lived asset may be capitalized if such costs are part of the historical cost of readying a long-lived asset for its intended use. Proponents of View A analogize to paragraph 6 of FAS 34, which requires capitalization of interest costs associated with construction of a long-lived asset as part of that asset's historical cost. Specifically, paragraph 6 states:

The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset. [Footnote references omitted.]

7. Under paragraph 18 of FAS 34, "the capitalization period shall end when the asset is substantially complete and ready for its intended use." Proponents of View A believe that, consistent with paragraph 18 of FAS 34, once the asset is substantially complete, capitalization of rental costs incurred during the construction period shall cease (for example, rental costs paid prior to a store opening and while store personnel are being trained but after the store becomes substantially completed, should be expensed).

8. Proponents of View A also analogize to paragraphs 6 and 7 of FAS 67, which provide for the capitalization of certain costs incurred during construction of real estate projects to be sold or rented. Such costs include real estate property taxes and insurance and other project costs that are clearly associated with the acquisition, construction, and development of real estate projects. Proponents of View A note that FAS 67 has been used as an analogy in practice to support the capitalization of rental costs related to ground leases incurred during construction of buildings on leased land, even though FAS 67 excludes from its scope the cost of real estate developed for an entity's own use. These proponents believe that there is no conceptual difference between ground rentals and building rentals and, thus, the analogy to FAS 67 should be extended to building rentals.

9. Proponents of View A also cite Issue 97-10 as support for capitalizing rental costs during construction. Issue 97-10 requires a lessee to include ground rental costs incurred during the construction period in determining whether the lessee is considered the owner of a real estate project for accounting purposes because these costs "are considered to be part of total project costs, consistent with GAAP." *Total project costs*, as defined in Issue 97-10, "include the amount capitalized in the project by the owner-lessor in accordance with generally accepted accounting principles (GAAP) plus other costs related to the project paid to third parties other than lenders or owners."

10. View A proponents note that AcSEC, in its *proposed SOP on certain costs and activities related to property, plant, and equipment*, believed that a distinction between ground lease rentals and building lease rentals was "arbitrary." Accordingly, View A proponents believe that since there is support under GAAP by analogy to FAS 34 and FAS 67 to capitalize rental costs

incurred during the construction of an asset being readied for its intended use, any distinction between whether the rental costs relate to ground leases or building leases would likewise be arbitrary.

11. Opponents of View A acknowledge that AcSEC believed that a distinction between ground lease rentals and building lease rentals was arbitrary. However, these opponents note that the draft SOP would have required expensing rental costs associated with both ground and building leases if the Board had cleared that document.

12. Opponents to View A also cite TPA 5600, which explicitly allowed capitalization of rental costs during construction and did not distinguish between ground and building leases. Based on discussions with the AICPA staff, TPA 5600 was rescinded after the issuance of SOP 98-5. SOP 98-5 requires costs of start-up activities and organization costs to be expensed as incurred. At the time, the AICPA staff believed TPA 5600 was too general and could therefore be inconsistent with SOP 98-5 in certain instances. Paragraph 5 of TPA 5600 stated, in part:

Under the present accounting model, certain costs may be added to an asset's acquisition cost until an asset is ready for its intended use. For example, under FASB Statement 34..., interest cost may be classified as part of a qualifying asset's acquisition cost during the period the entity is undergoing the activities necessary to get those assets ready for use. *By analogy, costs incurred by a lessee to get the leased premises ready for its intended use, including rental cost, may be deferred.* [Emphasis added.]

*View B: An entity may not capitalize rental costs associated with either ground or building operating leases that are incurred during the construction period.*

13. View B proponents believe that rental costs incurred during asset construction do not represent probable future benefits and therefore should not be capitalized. These proponents believe that rental costs represent costs incurred for the right to use property, plant, or equipment for a stated period of time. Paragraph 12 of Issue 01-8 states that "an arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment." View B proponents

believe that rental costs incurred during and after the construction period are for the right to control the use of the leased asset. Therefore, these proponents believe there is no distinction between rental costs incurred for controlling the use of the leased asset during and after the construction period.

14. View B proponents also believe that an analogy to FAS 34 is inappropriate. View B proponents believe that, unlike interest on borrowings, which is an avoidable cost, rental costs are not avoidable costs because the lessee does not own the leased property. Paragraph 51 of FAS 34 states, in part:

The Board concluded that the amount of interest cost to be capitalized should be the amount that theoretically could have been avoided during the acquisition period if expenditures for the asset had not been made. Clearly, interest cost can be avoided by repaying existing borrowings as well as by not borrowing additional funds. When an enterprise is contemplating investment in an asset, both those alternatives are available. When the decision to invest in the asset is made, those alternatives are rejected and the incurrence of interest cost during the acquisition period is a consequence of that decision. That cause-and-effect relationship between the investment in the asset and the incurrence of interest cost makes interest cost analogous to a direct cost in those circumstances.

15. View B proponents analogize to FAS 91, which provides guidance on the types of costs associated with lending activities and loan purchases that should be deferred and those that should be charged to expense as incurred. View B proponents analogize to paragraph 7 of FAS 91, which requires that "administrative costs, *rent*, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred" (emphasis added).

16. View B proponents note that in the proposed SOP on certain costs and activities related to property, plant, and equipment, AsSEC proposed that rental costs related to ground and building leases should not be capitalized during the construction period. AcSEC noted in paragraph A36 that the practice of capitalizing real estate taxes and insurance in FAS 67 was a specialized practice and that extension of that specialized practice to rental costs associated with either ground or building leases would be arbitrary and lead to the erosion of the basic cost

capitalization model developed by AcSEC in that proposed SOP. View B proponents note further that while the basic model developed by AcSEC allowed for the capitalization of costs necessary to ready an asset for its intended use, it specifically excluded both ground and building rental costs from that category of costs.

17. Additionally, View B proponents point to SOP 98-5, which provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred. View B proponents note that Illustration 3 of SOP 98-5 requires rental costs, incurred during the three-month period during which leased premises are being readied for their intended use, to be accounted for as start-up costs, which are expensed rather than accounted for as the historical cost of the leased premises under paragraph 8 of SOP 98-5.

18. Opponents of View B believe that rental costs incurred during construction of a long-lived asset are excluded from the scope of SOP 98-5. Paragraph 8 of SOP 98-5 excludes "costs of acquiring or constructing long-lived assets and getting them ready for their intended uses." Therefore, these opponents believe rental costs related to both ground and building leases are outside the scope of SOP 98-5.

*View C: An entity may capitalize only costs associated with ground operating leases incurred during the construction period.*

19. View C proponents believe that SOP 98-5 requires all start-up costs to be expensed, unless specifically provided for in other authoritative literature. Paragraph 6 of FAS 67 states that "costs incurred on real estate for property taxes and insurance shall be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress" (footnote reference omitted). Practice has extended the guidance in paragraph 6 of FAS 67 by analogy to ground rentals. Therefore, proponents of View C believe that SOP 98-5 would not be applicable to ground rentals.

20. View C proponents acknowledge that FAS 67 excludes from its scope the cost of real estate developed for an entity's own use and does not directly permit capitalization. However, since there is no literature that addresses the accounting for costs incurred to develop real estate for an entity's own use, FAS 67 has been applied and accepted in practice as being applicable to ground lease rental costs incurred to develop buildings for an entity's own use.

21. View C proponents believe SOP 98-5 does not apply to directly analogous costs, including ground lease rental costs, covered by FAS 67. However, View C proponents believe SOP 98-5 applies to rental costs associated with a building lease because there is no literature that is directly analogous to these costs (unlike ground lease rentals). Accordingly, these proponents believe that building lease costs must be expensed during the construction period.

22. View C proponents also believe Illustrations 1 and 3 of SOP 98-5 implicitly support their view. Illustration 1 of SOP 98-5 allows for the capitalization of long-lived asset additions, including the new plant, because those types of costs are included in paragraph 8 of SOP 98-5 (and therefore outside the scope of SOP 98-5). Accordingly, View C proponents believe ground lease rental costs may be capitalized into the cost of the new plant under Illustration 1. Illustration 3 requires the expensing of rental costs associated with getting leased premises ready for use. View C proponents believe that a specific purpose of Illustration 3 was to require the expensing of rental costs associated with leasehold improvements and, accordingly, building rental costs are not permitted to be capitalized as part of leasehold improvements. Opponents of View C believe there is no merit to how View C proponents view the purpose of Illustrations 1 and 3 of SOP 98-5.

23. View C proponents also note that Issue 97-10 only allows ground lease rental costs to be capitalized in determining whether the lessee is considered the owner of a real estate project for accounting purposes. View C proponents believe that building lease costs were explicitly excluded in Issue 97-10 because such costs are not capitalizable.

## **Effective Date and Transition**

24. The FASB staff's recommendation is that the consensus in this Issue should be effective for periods beginning after Board ratification of the consensus. Early application of this guidance is permitted in periods for which financial statements have not yet been issued.

25. The FASB staff proposes that the following views for transition should be considered by the Task Force:

- a. View A: Retrospective application to lease arrangements entered into prior to the effective date of the consensus in this Issue.*
- b. View B: Prospective application to lease arrangements entered into on or after the effective date of the consensus in this Issue.*

26. View A would provide more useful information because prior-period balance sheet amounts and prior-period income statement amounts would be restated to reflect the consensus in this Issue. However, retrospective application would likely require a significant amount of time and effort for lessees to review prior lease arrangements to determine the appropriate adjustments. The Task Force should consider the benefits and costs of requiring retrospective application and the need to provide entities with sufficient time to adopt the consensus.